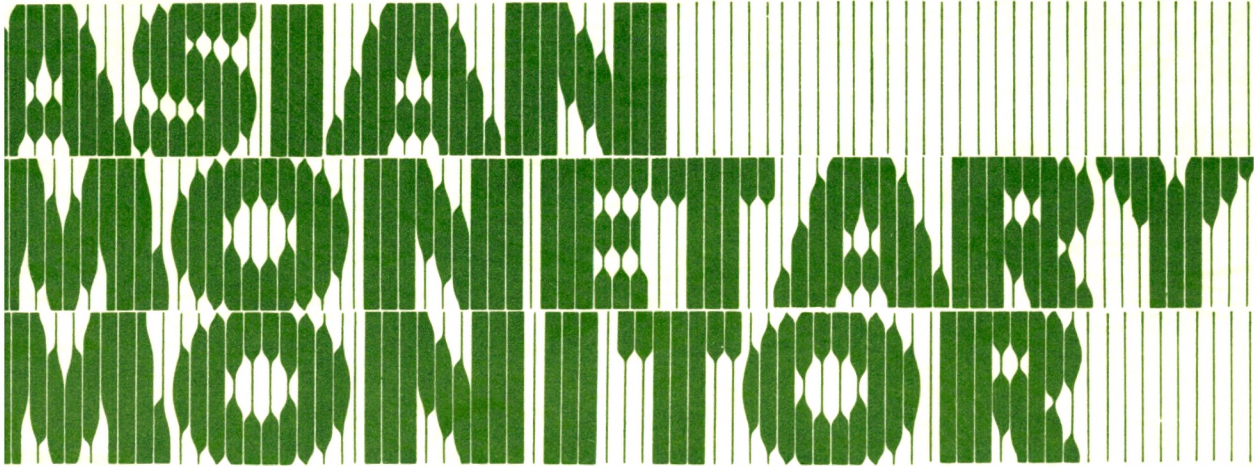




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KEYS TO SYMBOLS USED IN THE CHARTS

% RP	— Percentage Rate of change over Preceding period.
% RS	— Percentage Rate of change over Same period of preceding year.
SA	— Seasonally Adjusted.
SAAR	— Seasonally Adjusted at Annualised Rate.

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TAIWAN

A NEW BULL MARKET SIGNALS THE LIMITS TO STERILISATION

The Taiwan Stock Exchange Index rose 30.8% between August and December, more than any other stock market in the East Asian Pacific Rim. This was the first significant rally since the bull market of 1983-84 peaked out in May 1984, and offers the first suggestion that there could be a second upswing for Asian stock markets generally after the widespread setbacks of 1984 and 1985.

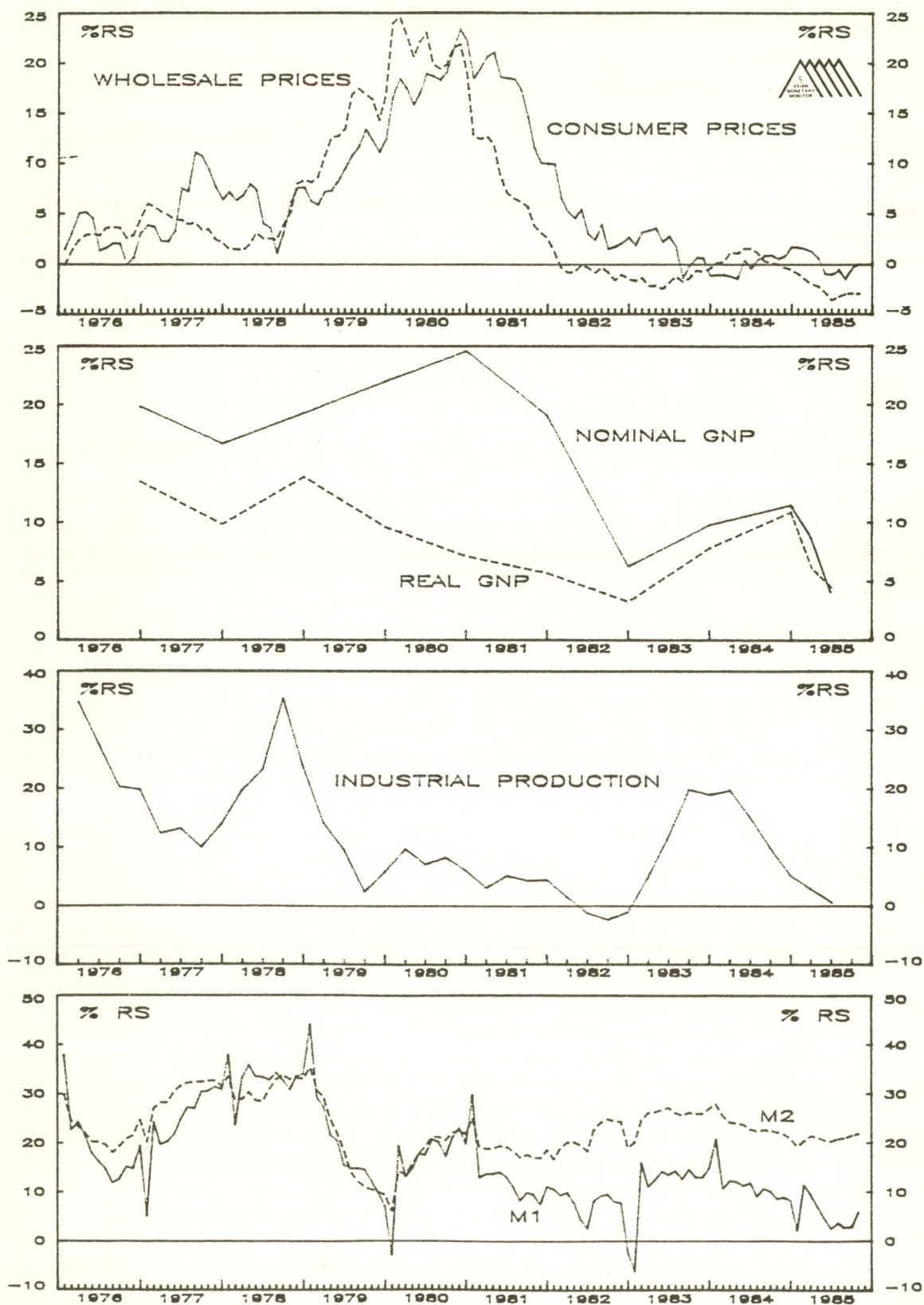
Chart 1 shows two of the basic factors acting as a depressant to asset values in 1984-85. First, at the bottom of the chart, year-to-year growth of both M1 and M2 peaked in January 1984 at 20.9% and 28.1% respectively, and then decelerated steadily through 1984 until January 1985. In the case of M2, growth slowed to 19.4% in January 1985, and has subsequently flattened out. The latest data show an increase of 22.7% in the year to November. In the case of M1, the deceleration continued for longer, though there was a temporary sharp upward spike in February 1985, so that the final trough was not until September 1985. Second, industrial production or manufacturing output slowed abruptly from the second quarter of 1984 as export growth peaked and gradually slowed over the next year to a trough of -2.4% (in US\$ terms) in the second quarter of 1985. The slowdown in output is not captured by the annual GNP data up to the end of 1984, but from 1984 quarterly GNP data became available for the first time, so our chart shows the year-to-year growth falling sharply from early 1985. Against an environment of tightening liquidity and slowing output growth it is not surprising to find that the stock market was falling from May 1984 until August 1985.

However, since August there has been a significant change in both these factors: liquidity has been improving and there are signs of an upturn on the external front. Added to this, interest rates have eased steadily through 1985. Assuming such trends persist, 1986 should prove highly favourable for stock market investment in Taiwan.

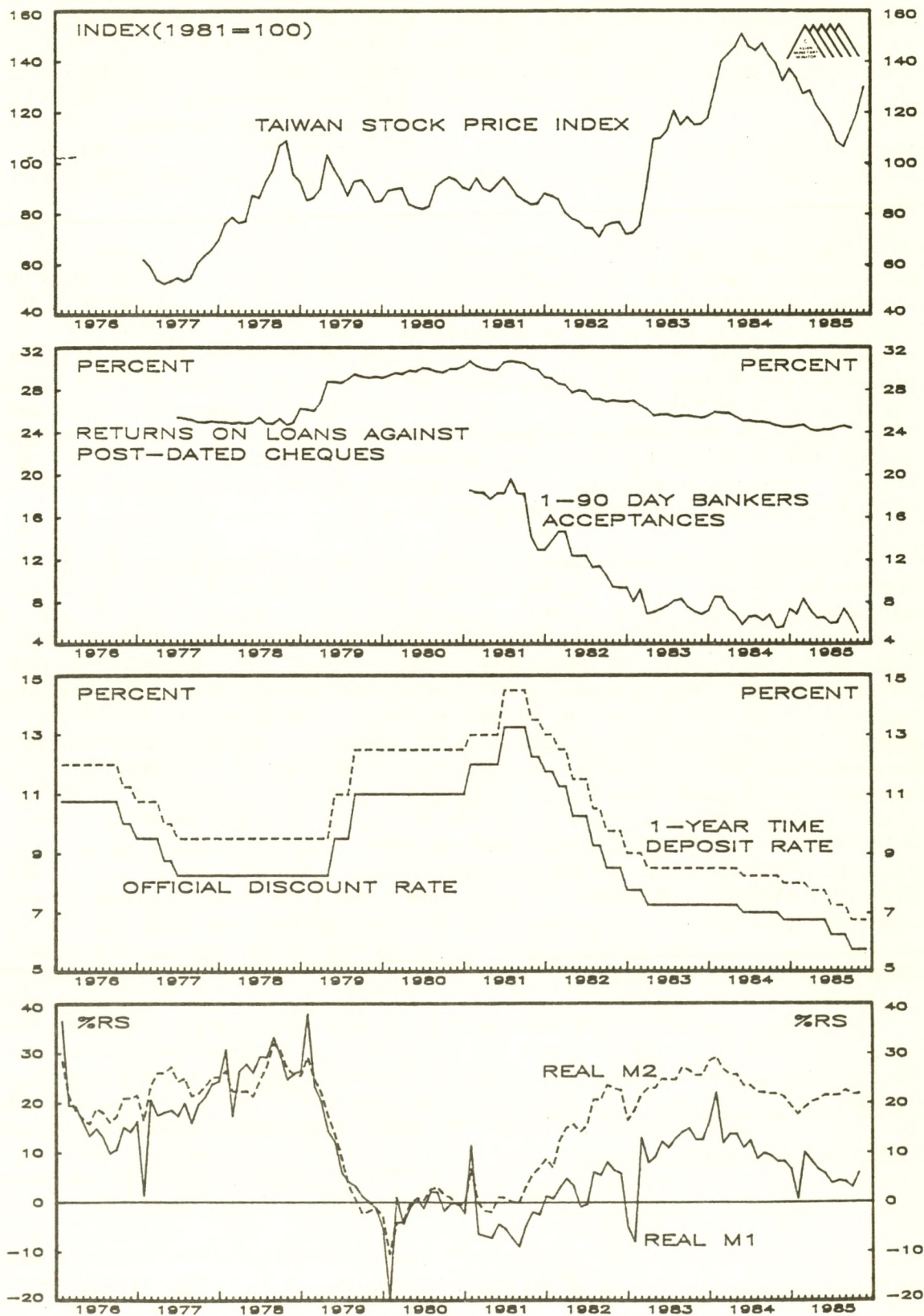
The remainder of this article reviews the relationship between stock market performance and liquidity trends since 1976, and the link between the stock market and export performance. We conclude with an analysis of the apparent switch in the central bank's tactics since 1980, and some recent changes as well some predictable consequences of this tactical shift.

Chart 2 illustrates the relationship between various liquidity indicators and the Taiwan Stock Price Index. Since 1976 there have been two bull markets, from July 1977 to October 1978, and from January 1983 to May 1984, together

TAIWAN: CHART 1
MONEY, OUTPUT AND PRICES



TAIWAN: CHART 2 LIQUIDITY INDICATORS AND STOCK PRICES



with the recent upturn - a rally which has not yet been sustained for long enough to qualify as a full-fledged bull market. Comparing first the trends in real monetary growth (in the bottom panel of Chart 2) and the stock market, the 1977-78 bull market was clearly associated with the improving trend of real M1 growth from around 10% year-on-year growth in mid-1976 to over 33.2% by August 1978, before the final upward spike to 37.9% in January 1979. Real M2 growth went from 16% in August 1976 to a peak of 30.7% in September 1978. In the early stages of this easy liquidity phase interest rates (shown in the third panel of Chart 2) were lowered in four successive stages from late 1976 to mid-1977.

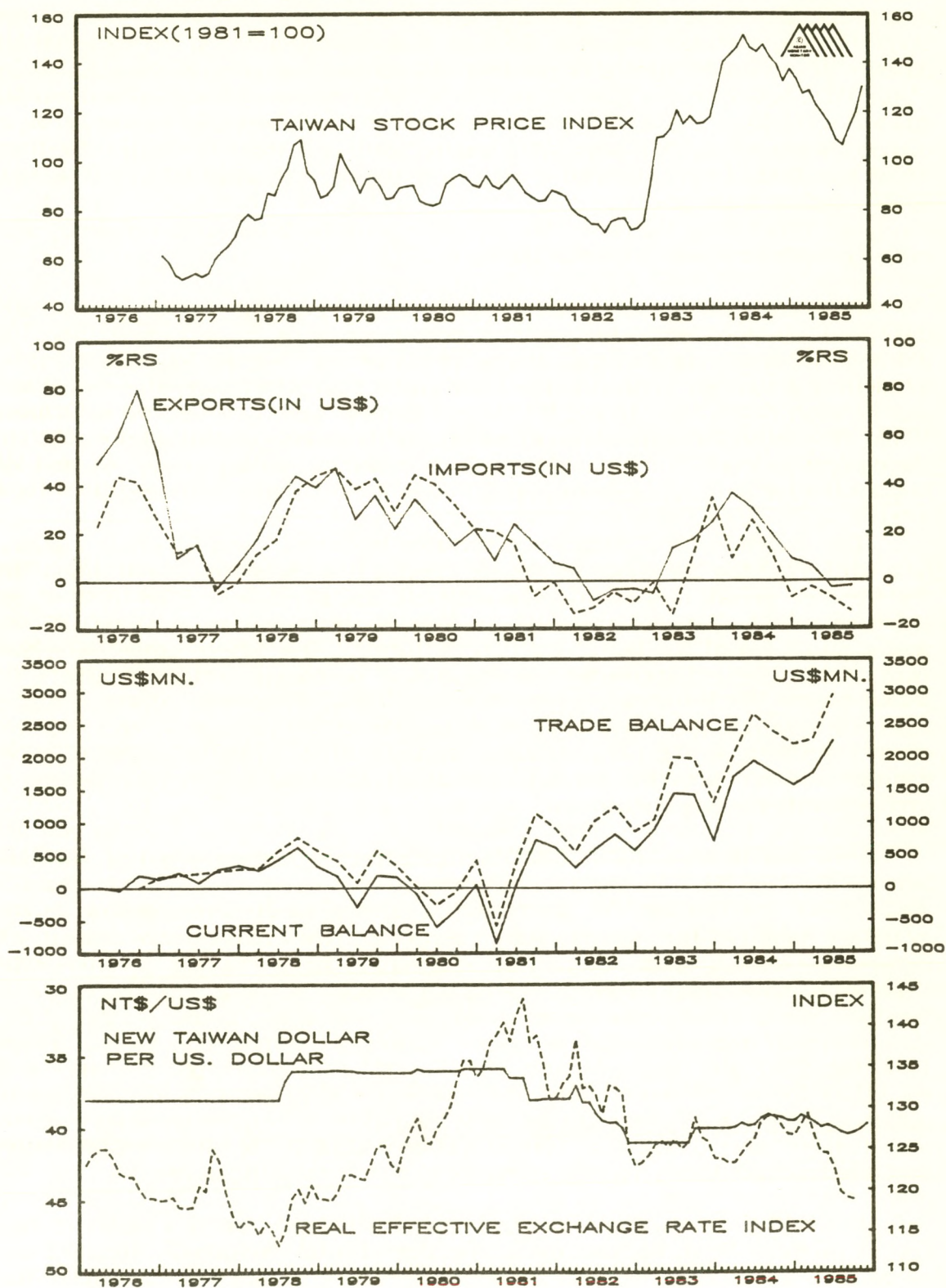
The onset of the second oil crisis in 1979 led the Taiwanese authorities to raise interest rates and tighten monetary conditions abruptly. The severity of the squeeze on real money growth was intensified by the prior revaluation of the NT\$ in June 1978, through its adverse effect on the balance of payments. The prolonged squeeze on liquidity (1979-1981) and the extended global recession prevented the Taiwan Stock Price Index from rising until liquidity was eased significantly from 1982 onwards. Interest rates started to come down in October 1981, and with the decline in inflation and an improvement in the current account (Chart 4) nominal M2 growth started to accelerate in 1982. As real M1 moved from negative territory to positive ground in 1982 the pre-conditions for a revival in the stock market fell into place.

Unlike Wall Street, however, which rose sharply from August 1982, the upturn in Taiwan's stock prices did not occur until early 1983. For an explanation of this it is useful to look at the relation between export performance and the stock market. The 1977-78 bull market discussed above was clearly associated with the export boom of 1977-78 and the improving trade balance over the same period (see the two middle panels of Chart 3). The long bear market of 1978-82 can also be seen against the background of the prolonged export slowdown from 1979 to 1983, and the initial deterioration in the external balance from 1978 Q3 to 1981 Q1. The key to recovery in the stock market in 1983-84 was obviously the export upturn (or expectations of it) from 1983 Q2, since liquidity had already been improving for some time and evidently was not sufficient on its own to create a bull market. The depreciation of the NT\$ against the US\$ from early 1981 until late 1982 (Chart 3, bottom panel) and the decline in the real effective exchange rate index were surely positive factors assisting the export recovery from 1983, but the main influence (discussed in our Regional Survey in the previous issue of AMM) was the resurgence of domestic final demand in the US economy from 1983 onwards.

With the depreciation of the US\$ since March 1985, and given the relative stability of the NT\$/US\$ rate over the period, the real effective exchange rate of the NT\$ has been falling (i.e. prices of Taiwanese goods are becoming more competitive in foreign markets) so that once again the foundations are being laid for an export-led expansion in Taiwan. However, since the US still accounts for over 48% of Taiwan's exports, the impact of any US recovery in 1986 will overwhelm other effects, and therefore the sustainability of Taiwan's incipient bull market will be crucially dependent on developments in the US in 1986.

Prior to 1980 because the currency was rigidly fixed to the US dollar and the central bank did little to offset the domestic impact of fluctuations in the

TAIWAN: CHART 3
CURRENCY, EXTERNAL TRADE AND STOCK PRICES



balance of payments, it was generally true that improvements on Taiwan's external accounts were invariably associated with a domestic monetary expansion, and hence with improving domestic liquidity - at least in the initial stages before inflation became serious. Conversely, a deteriorating external balance of payments invariably resulted in a domestic monetary squeeze. Since about 1980, however, and particularly since 1982 when the Taiwanese authorities started to manage the exchange rate of the NT\$ on a more ad hoc basis, that direct linkage has broken down. The reason for this is that the Central Bank of China (CBC) has been deliberately offsetting the net inflows of foreign exchange which derive from the current account surplus, in order to prevent these surpluses from having the disruptive expansionary effects on domestic money and credit growth such as occurred in the past.

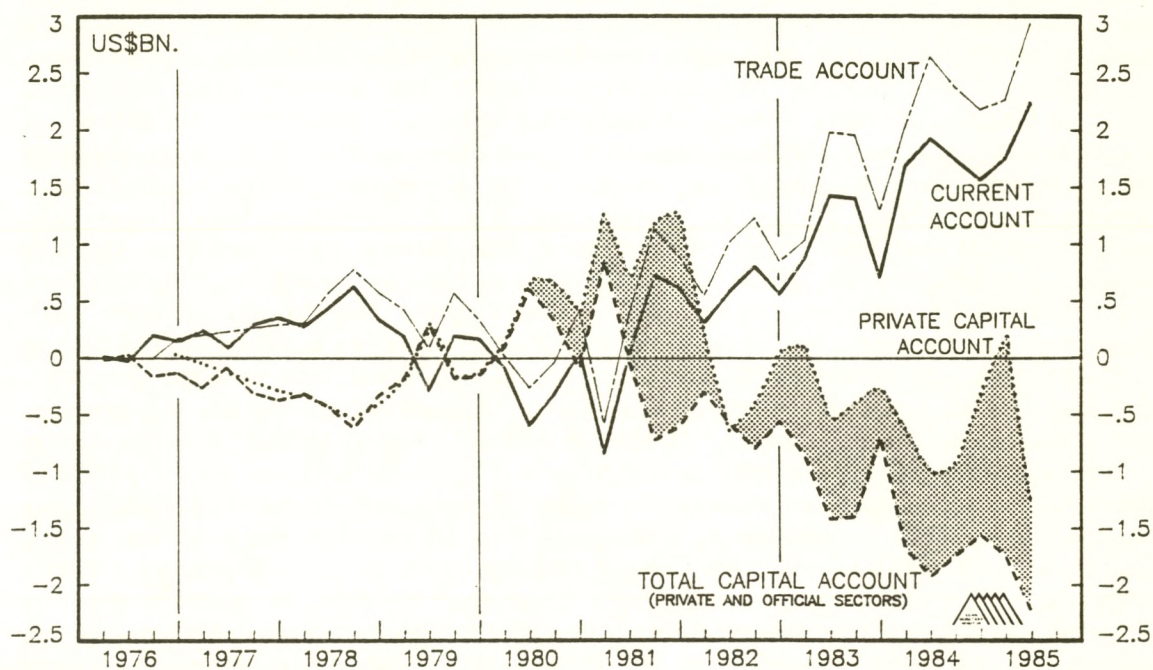
The consequence, so far as domestic liquidity and the stock market are concerned, is that domestic liquidity conditions have, to a degree, become independent of the state of the balance of payments. Thus for example in 1981-82, despite a strongly improving trade and current account (Chart 3), nominal M1 was decelerating (Chart 1) and M2 showed little upward acceleration until late 1982. (It was only the slowdown in inflation - itself independent of the state of the current account - rather than an upturn in nominal money growth which was responsible for the improvement in real money growth shown in Chart 2.)

The switch in CBC tactics is illustrated in Charts 4 and 5. Chart 4 shows how until 1980 the behaviour of private capital flows was virtually identical to the trend of overall (i.e. private plus official) capital inflows. From 1980 a gap starts to open up between these two, reflecting significant and growing official sector purchases of foreign assets (i.e. outflows). The difference between the two, or the amount accounted for by official purchases of foreign assets, is shown by the shaded area between the two lines. In essence private capital outflows have not been large enough to counteract the cumulative surpluses on current account, so the CBC has added to the outflow in order to equate total capital outflows with the surplus on current account, and thereby keep the exchange rate roughly unchanged.

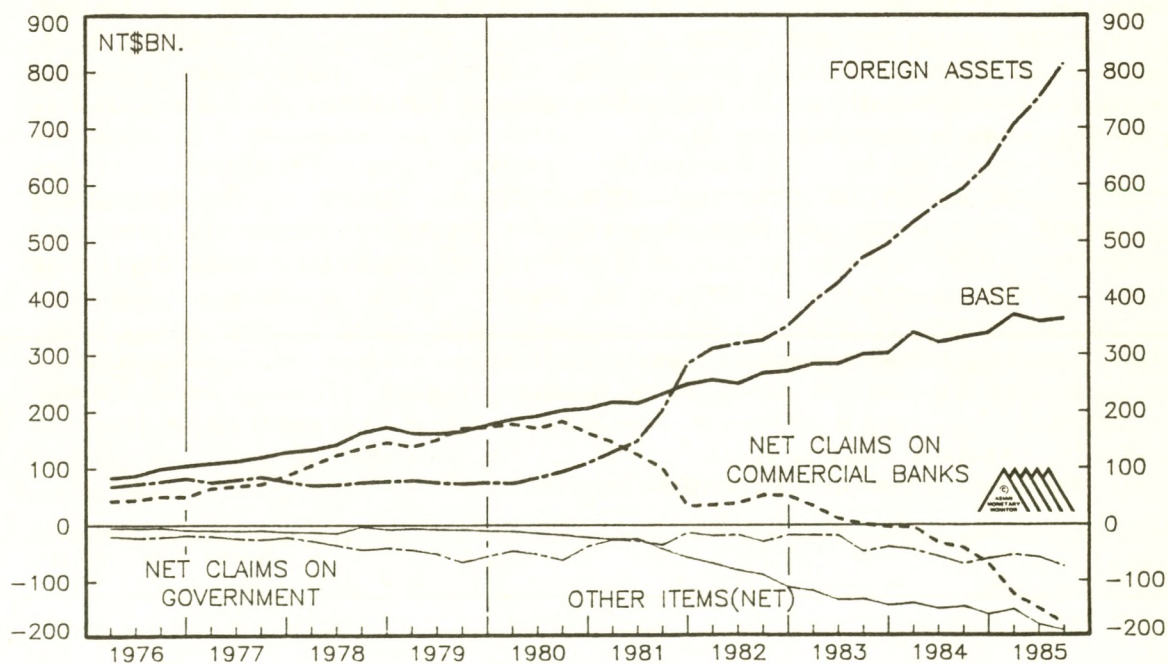
How has this switch in CBC tactics affected monetary policy and the balance sheet of the CBC itself? The answer to this question is shown in Chart 5 which plots the components of the CBC balance sheet corresponding to its monetary liabilities (i.e. the monetary base, or currency plus reserve deposits of commercial banks). As the current account surplus started to build up from 1981 the central bank bought foreign assets, but to prevent the acquisition of these foreign assets being translated into a monetary expansion the CBC simultaneously reduced its loans to (net claims on) commercial banks. From 1981 the CBC also began to use other assets to buy foreign currency and securities (other items net), and from 1984 the CBC actually became a net borrower from the commercial banking system as its net claims on banks became negative. In short the banking system was depositing funds with the CBC which used the proceeds to buy foreign exchange to add to the official reserves.

It would seem that this curious state of affairs is largely a result of two sets of factors. First, because the authorities wish to maintain a basically fixed exchange rate but at the same time because they do not wish to suffer the disruptive monetary consequences of fluctuations in the balance of payments,

TAIWAN: CHART 4
CURRENT AND CAPITAL ACCOUNTS OF THE BALANCE OF PAYMENTS



TAIWAN: CHART 5
COMPONENTS OF THE MONETARY BASE



they have been obliged to engage in massive offsetting or "sterilising" operations. There are, however, limits to which it is possible to continue with these manoeuvres, and largely as a result Taiwan is starting to experience a significant upturn in monetary growth and domestic liquidity. Second, and more fundamentally, it is the deliberate restrictions on imports and capital outflows which are at the root of this problem. Taiwan has a wide range of import controls (tariffs, quotas, non-tariff barriers etc.) which limit imports, and a tax and financial structure which subsidises or promotes exports, thus contributing to the trade and current account surpluses. At the same time capital controls have prevented the private sector from acquiring foreign assets so that the private sector capital outflows have simply been inadequate to offset the current account surplus. Hence, given the distortions of the tax structure, the monetary authorities have had no choice in the short term but to accumulate huge quantities of reserves. Taiwan's foreign exchange reserves totalled US\$22 billion in December, equivalent to US\$1162 per capita. In absolute terms the Republic of China (ROC) holds the sixth largest stock of reserves among all countries of the world after West Germany (US\$42.8 billion), Japan (US\$27.6 billion), the United States (US\$27.2 billion), Saudi Arabia (US\$25 billion) and France (US\$23 billion). Taiwan's reserves exceed the value of one year's imports, far in excess of any conceivable requirement, and amount to an extraordinary 38% of GNP. There is little real benefit in Taiwan holding such a large stock of foreign reserves, but it is becoming increasingly clear that the CBC is reaching the end of its ability to sterilise the ever-rising pile of foreign exchange. As a result the authorities are being compelled by the inescapable logic of the situation to ease the underlying restrictions and controls which have brought about the massive accumulation of reserves.

On December 24 the CBC therefore announced new regulations permitting financial institutions, corporations and individuals to invest in foreign government securities and financial obligations of banks (i.e. deposits, CDs, bank-issued debentures etc.). However, the purchase of equity shares in foreign private companies will still be prohibited, and any purchases are subject to a 2-year minimum investment period before they can be redeemed. In the short term this could act as a substantial disincentive to capital outflows. Another recent move adding to currency outflows was the easing of the regulations governing remittances for Taiwanese citizens travelling abroad (for the fifth time since 1979), and the relaxation of restrictions controlling which particular banks Taiwanese citizens could use to deposit foreign exchange. The new arrangements permit three domestic banks to offer foreign currency accounts. (Until recently non-designated financial institutions such as trust and insurance companies were barred from even holding foreign exchange and foreign securities.) Assuming a policy decision has been taken to prevent an explosion in domestic money growth it is likely that further measures to liberalise foreign investment will follow in the months ahead.

FORECAST: Starting around 1980-81 the Taiwanese authorities have been busily sterilising inflows of foreign exchange in order to prevent the overall balance of payments surplus from being translated into a rapidly expanding money supply. The net foreign assets of the Central Bank of China (CBC) are now more than double the size of the monetary base, and the CBC is finding it increasingly difficult to counteract the continuing accumulation of foreign assets. The authorities face two basic options: either to revalue the currency upwards against the dollar (something they are reluctant to do following the disastrous experience of 1978), or to liberalise the controls on imports (to reduce the trade surplus) and outward capital flows (to balance the current account surplus). The authorities seem unready to revalue the exchange rate or allow the NT\$ to float freely. Therefore over the coming months there must be further moves towards liberalisation. However, with the US\$ depreciating on world currency markets and the NT\$ weakening in line with the ~~NT\$~~^{US\$}, the balance of payments is likely to remain so strong that if the Taiwanese authorities are to prevent a monetary explosion they will ultimately be forced to resort to the first option - namely an upward revaluation or floating of the currency. It is simply a matter of time.

THAILAND

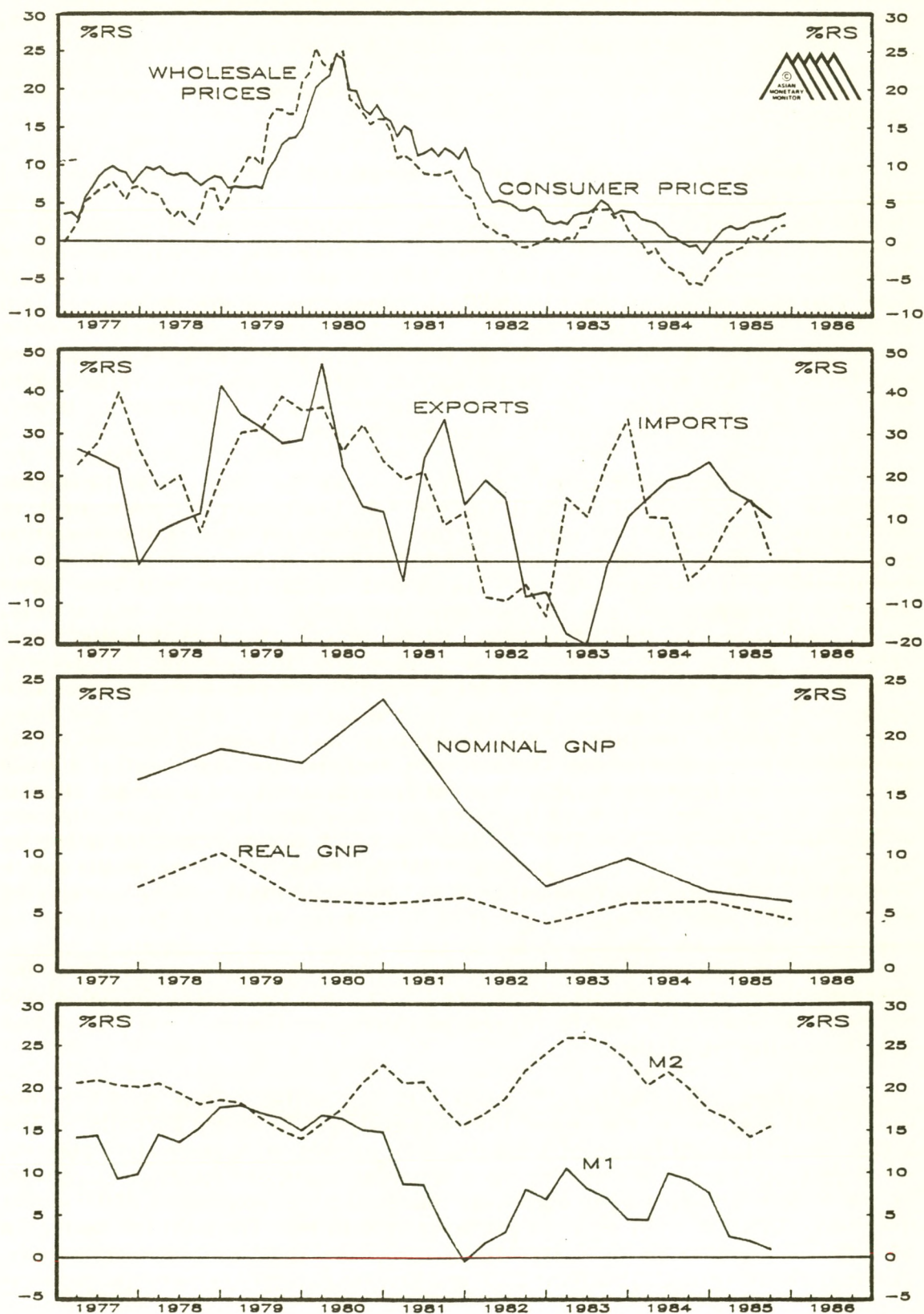
RIISING EXTERNAL INDEBTEDNESS CONSTRAINS MONETARY POLICY

1985 was a difficult year for the Thai economy. The record 14.8% devaluation of the Baht on November 2nd 1984 failed to achieve any narrowing of the trade and current account deficits. (The trade deficit for 1985 is likely to turn out to have been marginally larger than 1984's Baht 68.8 billion deficit.) Also, the devaluation failed to result in the expected pick-up in monetary growth (see AMM Vol. 8 No. 6). Instead, the year-on-year rate of M2 growth fell from 21.8% at the time of the devaluation to 15.4% by September, continuing a downtrend which stretches back to late 1983 (see Charts 1 and 4). The economy itself experienced one of its poorest years in two decades, with the growth rate of real GDP falling to 4.4%, from 6.0% in 1984. Most private forecasters predict even worse ahead in 1986, with the Thailand Development Research Institute, for instance, forecasting that the economic growth rate will drop to 3.2% in 1986, lower than any other year in the post-war period.

The exchange rate for the Baht is a sensitive issue in Thailand, and the November 1984 devaluation was a very controversial move which threatened for a time to plunge the country into a political crisis. Thus, in the light of subsequent economic events, it is not surprising that critics of the devaluation and the accompanying switch to a more flexible exchange rate regime, have been quick to proclaim it a failure. This is perhaps unfair because the international trade environment has been particularly adverse for Thailand over the past year, and it is likely that in the absence of devaluation, Thailand's trade position would have been markedly poorer than it is now. In particular, Thailand has been very hard hit by continuing weak prices for its agricultural commodity exports (with rice, maize and tapioca prices, for instance, down 15%, 20% and 5% respectively from year earlier levels over the first nine months of 1985) and the protectionist measures taken against Thai textile exports, as well as the slowdown in the US economy. Nevertheless, it is true that Thailand's continuing large current account deficits are becoming a major problem for the economy and are increasingly obstructing the implementation of an effective monetary policy by the Bank of Thailand (BOT). The new exchange rate regime does not appear to have helped at all in this respect, but rather become a victim of the continuing problems hindering monetary policy.

Previous issues of AMM have discussed in detail the rather peculiar workings of the Thai monetary system. Briefly, in the past, for institutional and technical reasons Thai interest rates tended to be very rigid. However, because the Thai Baht was also pegged rigidly to the US dollar, large corporate borrowers in Thailand with access to foreign credit and capital markets were able to borrow abroad, particularly in US dollars when the US-Thai interest rate differential was advantageous to them, without any exchange rate risk. The result was that the interest rate differential with the US - in practice meaning US interest rates, as Thai rates were very inflexible - played a causal role in determining the overall balance of payments position and hence the rate of monetary growth, rather than the reverse as would normally be the case in a fixed exchange rate economy. Thus if, for instance, US interest rates were in a

THAILAND: CHART 1
MONEY, OUTPUT, TRADE AND PRICES



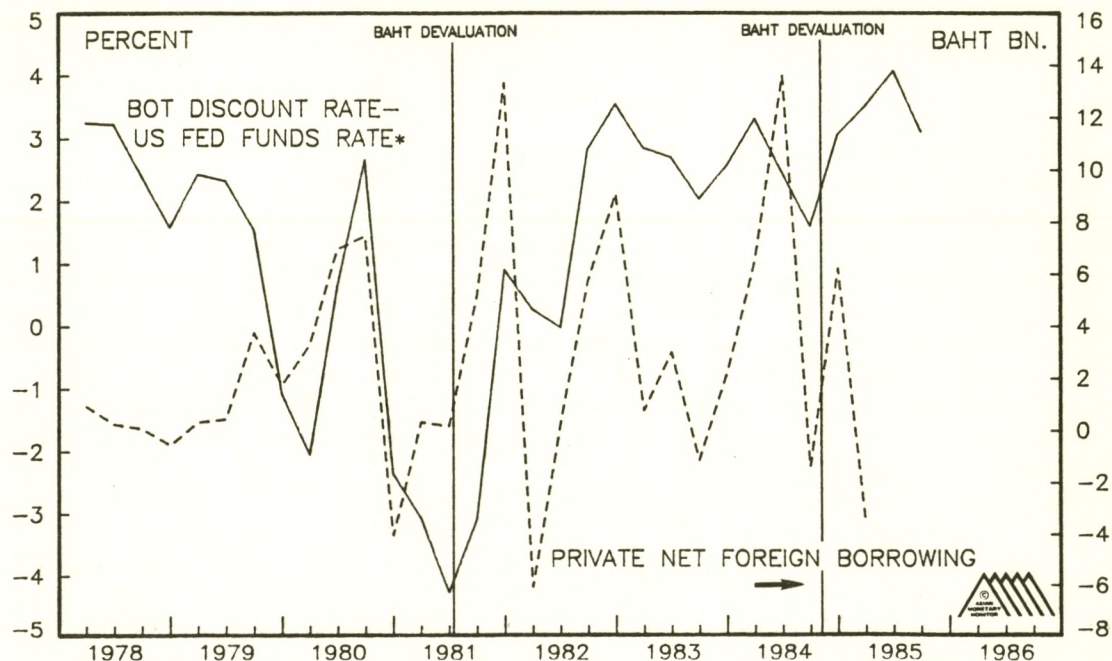
downtrend (as over the period mid-1981 to mid-1983) private corporate borrowers would turn increasingly to US dollar borrowings, thus boosting long-term capital inflows and the overall balance of payments position and hence, under the fixed exchange rate regime, raising the rate of monetary growth (see Charts 2, 3 and 4). Thus, monetary conditions in Thailand became a captive of US interest rates and US monetary policy and the BOT had little scope to pursue an independent monetary policy.

In theory the adoption of a new exchange rate regime (under which the Baht would be managed against a basket of currencies, rather than fixed rigidly to the US dollar) along with the greater flexibility supposedly imparted to interest rates by various BOT measures and the increasing sophistication of the Thai financial community (see AMM Vol. 7 No. 4 and AMM Vol. 8 No. 6) should have weakened the causal links in the chain connecting US interest rates to Thai monetary growth, and given the BOT some flexibility to influence domestic monetary conditions independently. In practice, however, in 1985 at least the new exchange rate regime appeared simply to introduce one more variable into the equation - expectations with regard to the exchange rate, influenced largely by the trend of the US dollar on the foreign exchanges.

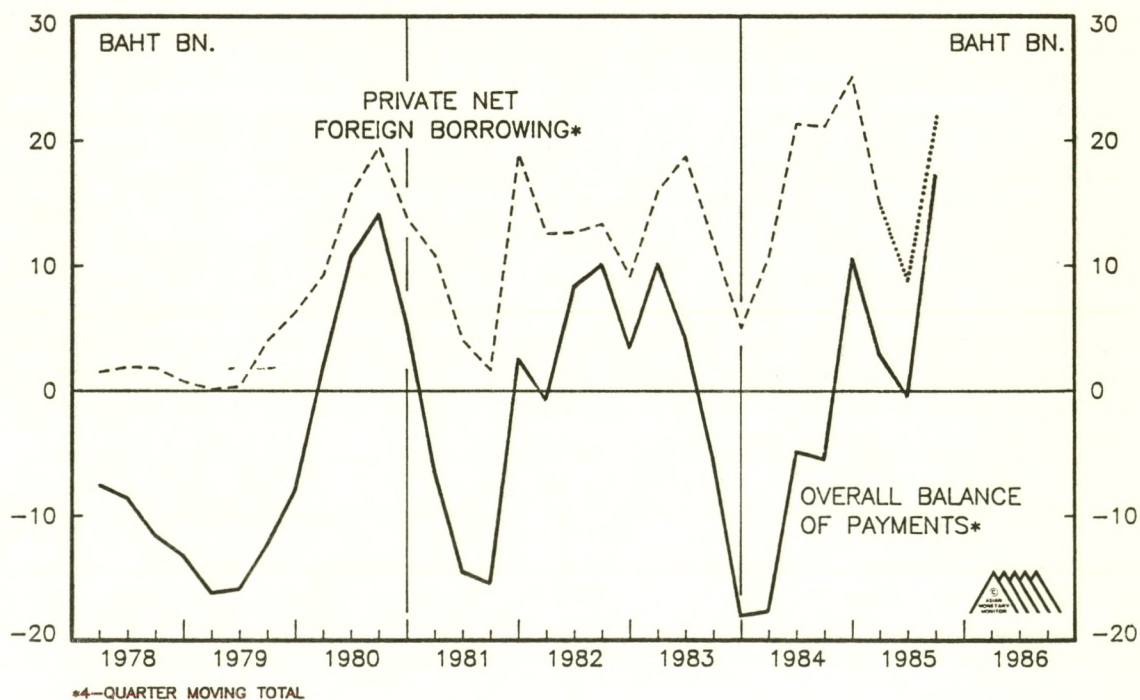
The new exchange rate policy, announced at the time of the November 1984 devaluation, involved the linking of the Baht to a basket of currencies, with BOT reserving the right to vary the value of the Baht against the basket in response to domestic economic or international financial considerations, specifically with reference to trade flows and capital movements (the latter effectively meaning private net foreign borrowing). Although the specific weightings given to the component currencies of the basket were never announced, private sector observers were soon able to ascertain that roughly 50% of the basket comprised the US dollar and 25% the yen, with the other 25% comprising the Deutschemark, sterling and the Malaysian, Singapore and Hong Kong dollars. At the time of the devaluation and change of exchange rate regime, US interest rates had already been declining for two months, a trend which continued throughout 1985. Normally, devaluation and lower US interest rates would be expected to have triggered an immediate surge in capital inflows, as happened after the July 1981 devaluation which occurred against a similar international economic background (see AMM Vol. 8 No. 6). Indeed, in the month immediately following the devaluation (i.e. November 1984) private net foreign borrowing did pick up sharply, resulting in a large Baht 7.5 bn balance of payments surplus for the month and a 1.6% upward blip in monetary growth. November's private net foreign borrowings explain the marked increase in the quarterly figure (for 1984 Q4) depicted on Chart 2 and the peak in the balance of payments as a whole in the fourth quarter, shown on Charts 3 and 4 on a four quarter moving total basis.

However, despite falling US interest rates, capital inflows quickly turned into capital outflows at the end of 1984 and early 1985. As the US dollar soared in the final 'blow-off' stage of the dollar bull market in January and February, the Baht slipped lower in line with the weaker yen, mark and sterling components of the basket, and corporate borrowers made massive repayments of US dollar borrowings in an attempt to avoid exchange rate losses. The Baht reached a low of US\$1 = Baht 28.33 in early March compared with the immediate post-devaluation fixing of US\$1 = Baht 27.0, and private enterprises were net repayers

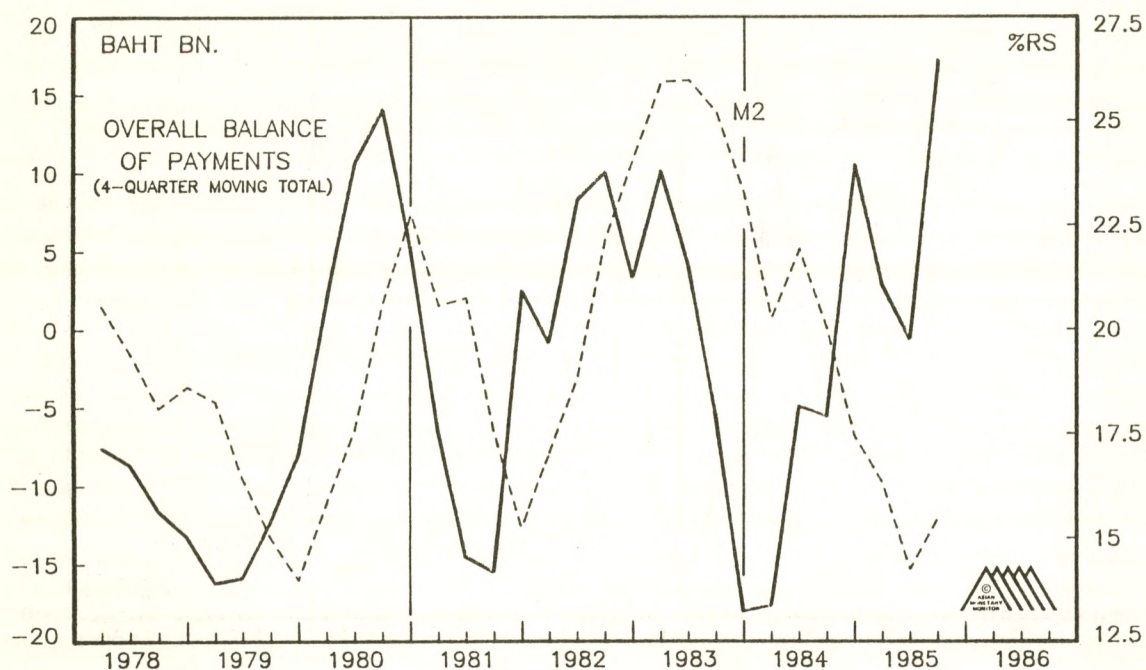
THAILAND: CHART 2
INTEREST RATES AND PRIVATE NET FOREIGN BORROWING



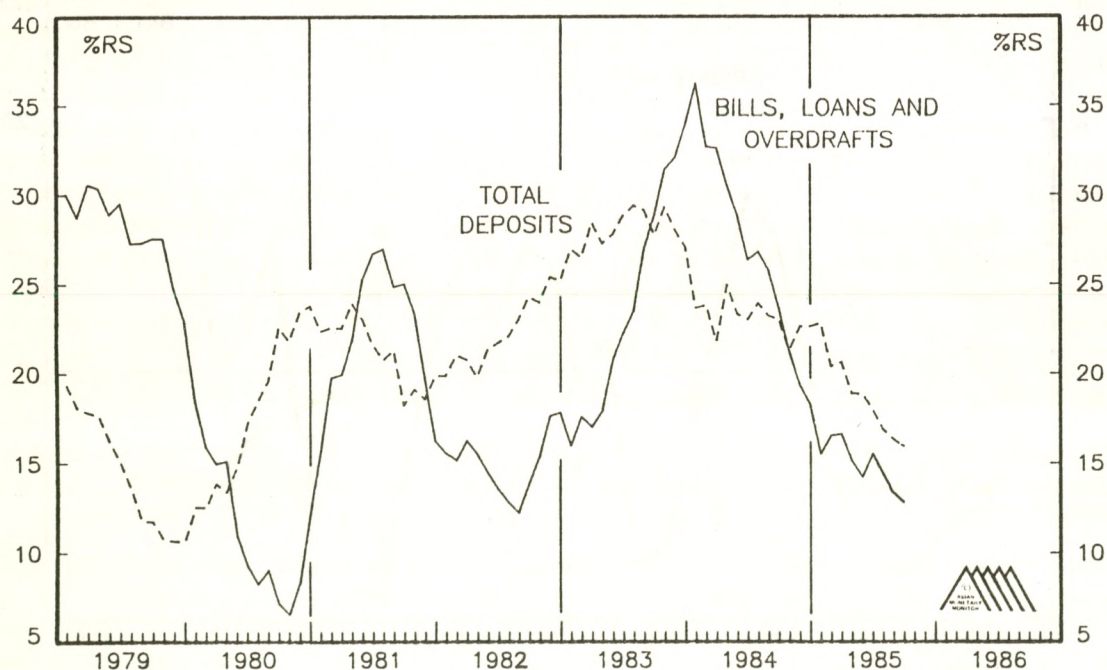
THAILAND: CHART 3
PRIVATE NET FOREIGN BORROWING AND THE BALANCE OF PAYMENTS



THAILAND: CHART 4
THE BALANCE OF PAYMENTS AND MONEY GROWTH



THAILAND: CHART 5
BANK LOANS AND DEPOSITS



of Baht 3.6 bn of debt in the first quarter of 1985. In a sense, the adverse effect of the resultant first quarter balance of payments deficit on liquidity was prolonged by the behaviour of the commercial banks themselves. To overcome the tightness of liquidity in the banking system, commercial banks borrowed abroad heavily at the end of 1984 and early 1985, raising gross borrowings from banks abroad to a very high level of Baht 50.9 bn by March. The reduction in these outstanding banks' overseas borrowings over subsequent months offset, to a degree, the favourable impact on liquidity of renewed non-bank borrowings as the dollar weakened from March.

However, these monetary capital outflows do not by themselves explain why the monetary growth rate continued to fall even as the US dollar began on a sharply weakening trend - from March 1985 - which has continued until the time of writing. The key reason for the continued decline in monetary growth was marked weakness in bank lending continuing throughout 1985 (see Chart 5), a major reason for which, in turn, apart from caution on the part of the commercial banks, was the failure of the banks to reduce interest rates significantly. Instead, the banks preferred to invest excess reserve assets in high-yielding government securities. In the second quarter of 1985 (the most recent quarter for which detailed statistics are available at the time of writing) net purchases of government bonds and Treasury bills by the commercial banks totalled Baht 5.5 bn, most of which were purchased from BOT. Thus, even though high Thai interest rates and the weakening dollar encouraged large capital inflows into Thailand from March, the sales of government debt by BOT associated with the weakness of bank lending totally offset the external expansionary effect on the monetary base and resulted in a continuing decline in monetary base growth.

The failure of commercial banks' deposit interest rates and prime lending rates to decline in line with inter-bank rates in the supposedly now more flexible interest rate environment was partly due to the large commercial banks' recurring fear of losing deposits to smaller banks and finance companies, but also partly reflected government policy in maintaining the yield on government bonds at high levels (11% or above) despite heavy oversubscriptions for new issues. Interest on bank deposits is subject to 12.5% withholding tax (proposed to be raised to 17.5%), whereas interest payments on government debt are not subject to tax. With government securities yielding 11% and above, the commercial banks were unwilling to reduce fixed deposit rates below 11%. Thus, although inter-bank and 3-day bond repurchase rates came down from 17.5% and 13.125%, respectively, in March to 12% and 9.87%, respectively, by August, minimum lending rate was only reduced once during that period - by 1% in August. On December 26 BOT moved to reduce official interest rate ceilings in an apparent effort to encourage lower interest rates, but the 1/2% reduction in the maximum lending rate - to 17%, and the 2% reduction, to 11%, in the ceiling on deposit interest rates effectively only brought official ceilings into line with existing market rates.

The authorities appear to have been unwilling to force - or allow - a larger reduction in interest rates for fear of the possible consequences for the level of private capital inflow i.e. private sector net foreign borrowing. This fear can also be seen in official exchange rate policy. Following the September 22nd G-5 meeting, BOT failed to appreciate the Baht vis-a-vis the US dollar as far as

would have been implied by the basket, instead keeping the Baht at around the US\$1 = Baht 26.5 level as the dollar fell sharply against the yen and mark. The immediate response from the corporate sector was a capital outflow, as companies feared that the BOT was attempting covertly to depreciate the Baht. As a result, BOT was forced to raise the Baht back up to the level against the US dollar implied by the basket. The ultimate consequence was that, in early December, BOT announced an explicit 2% depreciation of the Baht against the US dollar and announced that they would further reduce the volatility of the Baht/dollar rate in the future, tantamount to the virtual abandonment of the previous currency basket concept.

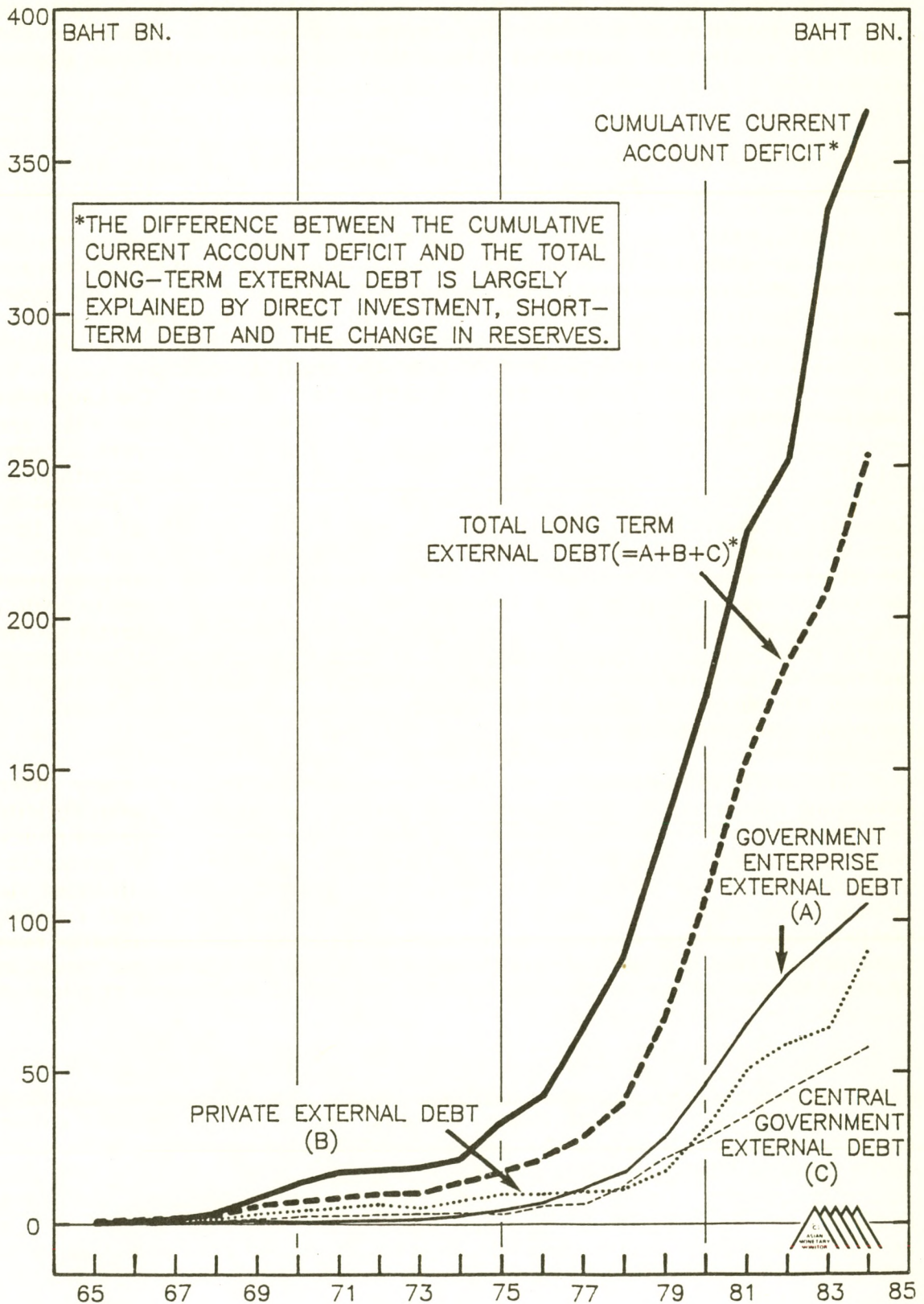
Thus although, over recent years, the BOT has moved to create a financial environment conducive to the operation of a more independent monetary policy, monetary and exchange rate policy has now been turned to the need to, above all, promote a high level of capital inflow to finance Thailand's persistent current account deficits. It is this effective change in policy which is noticeable on Chart 4 where it is reflected in the recent failure of monetary growth to respond to a change in trend of the overall balance of payments. The long-term problem forcing the change is illustrated on Chart 6 (data for 1985 are unfortunately not yet available) which depicts the cumulative current account deficit since 1965 and the build up of central government, government enterprise (i.e. state enterprises such as Thai International, the Electricity Generating Authority & the railways) and private enterprise (i.e. corporate) debt (the cumulative total of private net foreign borrowing shown on Charts 2 and 3) which has largely financed the cumulative current account deficit. The emerging trend for current account deficits to be financed through private, as opposed to public, long-term borrowing can be seen from this chart. This has occurred as the central government has begun to attempt to bring its own external borrowings and those of the state enterprises under control, but BOT has thus been forced to transfer the burden of financing the current account deficit on the balance of payments onto the private sector.

Thailand's debt problem resembles that of Malaysia, and many other developing countries, in that effectively many years of current account deficits have never been financed in a 'permanent' way. However, in a monetary policy sense, in Thailand's case the problem is more acute because a high proportion (roughly 25%) of the cumulative current account deficit has been financed via private foreign borrowings which are outside the government's direct control, highly volatile and very sensitive to international interest rate and exchange rate movements. Thus a major policy alternative - devaluation - is almost closed to Thailand because of the possible implications for capital movements of a loss of confidence in the exchange rate.

Thailand's external debt problem is not yet acutely serious but it is beginning to represent a major constraint to the operation of an effective monetary policy. The total long-term debt (of central government, state enterprises and private enterprises) shown in Chart 6 now totals roughly Baht 270 bn (or roughly US\$12 bn using an average exchange rate of US\$1 = Baht 22). Adding short-term credits gives Thailand a total external debt of US\$14 bn, making it the Third World's 14th largest debtor. The total debt service ratio is estimated by private sector observers to stand at around 28%, and is likely to rise above 30% within the next year. More pessimistic domestic bankers and

THAILAND: CHART 6

CUMULATIVE CURRENT ACCOUNT DEFICIT AND THE DEBT BUILD-UP



analysts foresee the likelihood of the country being effectively bankrupt before the end of the decade. This latter view may be alarmist but it is certainly true that ultimately Thailand's large foreign borrowings will have to be drastically curtailed through an elimination of the current account deficit - if not through a major improvement in commodity prices, then through a reduction in imports brought about by a period of recession in the domestic economy.

FORECAST: Liquidity conditions in the Thai economy are likely to become markedly easier in 1986. While increased confidence in the Baht/US dollar exchange rate and the continuing large interest rate differential in Thailand's favour are likely to encourage a high level of private foreign borrowing, the domestic component of monetary base growth is also likely to be expansionary as BOT will be involved in more direct lending to the private sector. For the longer term, however, unless the problem of Thailand's persistent current account deficit is solved, the current account deficit is eventually likely to be reflected in much tighter domestic liquidity conditions and much slower economic growth, because the level of Thailand's external debt is fast approaching its tolerable maximum level.

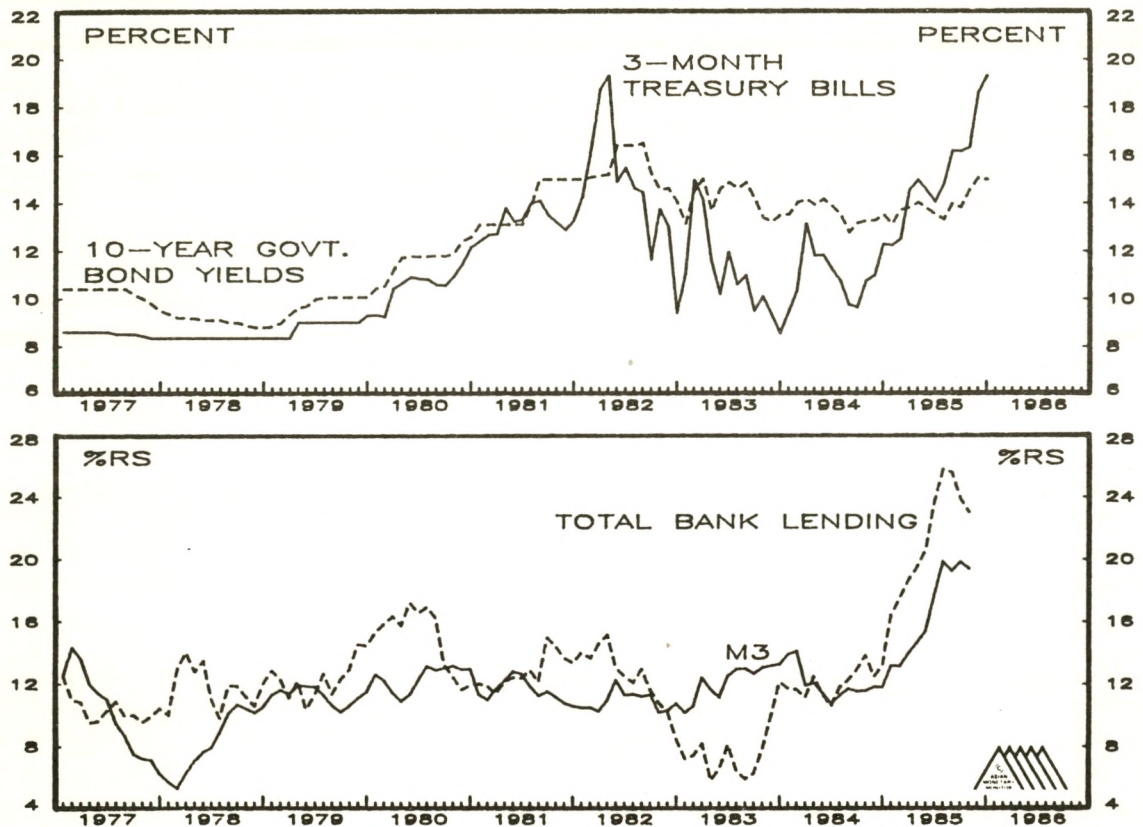
ECONOMIC CAPSULES — A NEW FEATURE

With this issue Asian Monetary Monitor introduces a new feature - Economic Capsules - which we believe will bring a twofold benefit to subscribers. First, the brevity of each capsule will enable AMM to comment on developing trends on a more timely basis without the need for a full length article. Second, extending our coverage to more countries in each issue will give our subscribers better value for money.

The Editor

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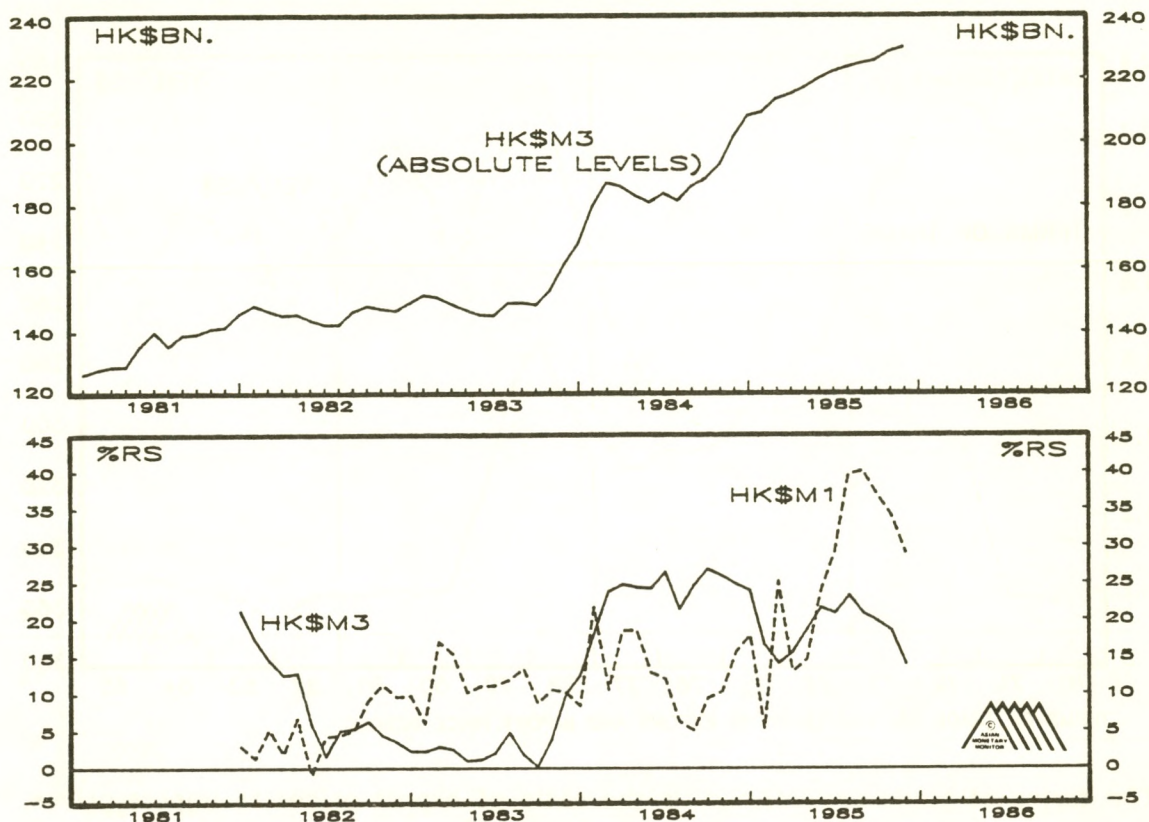
AUSTRALIA: NO IMMINENT FALL IN INTEREST RATES



A survey of the evidence suggests little hope for falling interest rates in the near term in Australia. M3 increased by +19.3% in the year to October and 18.6% in the year to November. Early in 1985 the government abandoned its 8-10% M3 target, on the grounds that deregulation made M3 an unreliable indicator. To date it has not been replaced with any alternative target. Most sectors of the economy have remained very buoyant. Currency, which is a reasonable proxy for nominal consumption spending, rose 11.5% in the year to November. Real GDP rose 5.7% in the September quarter from a year earlier. Reflecting the strength of the economy bank lending has grown very strongly (see chart above), with the year-to-year growth of loans and discounts at major trading banks up 25% in November. Other indicators of economic activity are also strong - for example, employment is rising well above trend (and above the Treasury's projection), and in the September quarter the Bureau of Statistics' measure of industrial production was up 5.2% on the year. The inflation picture is worsening in the short term as the price effects of the November depreciation of the A\$ will be coming through in the March quarter. Also wages are expected to accelerate through 1986 to almost double the rate of 1984. Currently 90-day prime commercial bills are hovering around 20%, and rising, NCDs and Treasury Notes are about 19%, and 20-year Treasury bonds yield 13.85%, down from 15.15% a month ago, but with the inflation outlook deteriorating, one cannot be too optimistic about the immediate prospects.

Basically it doesn't look as if the authorities have yet squeezed hard enough or long enough to slow the economy, weaken credit demand, and thus permit interest rates to fall.

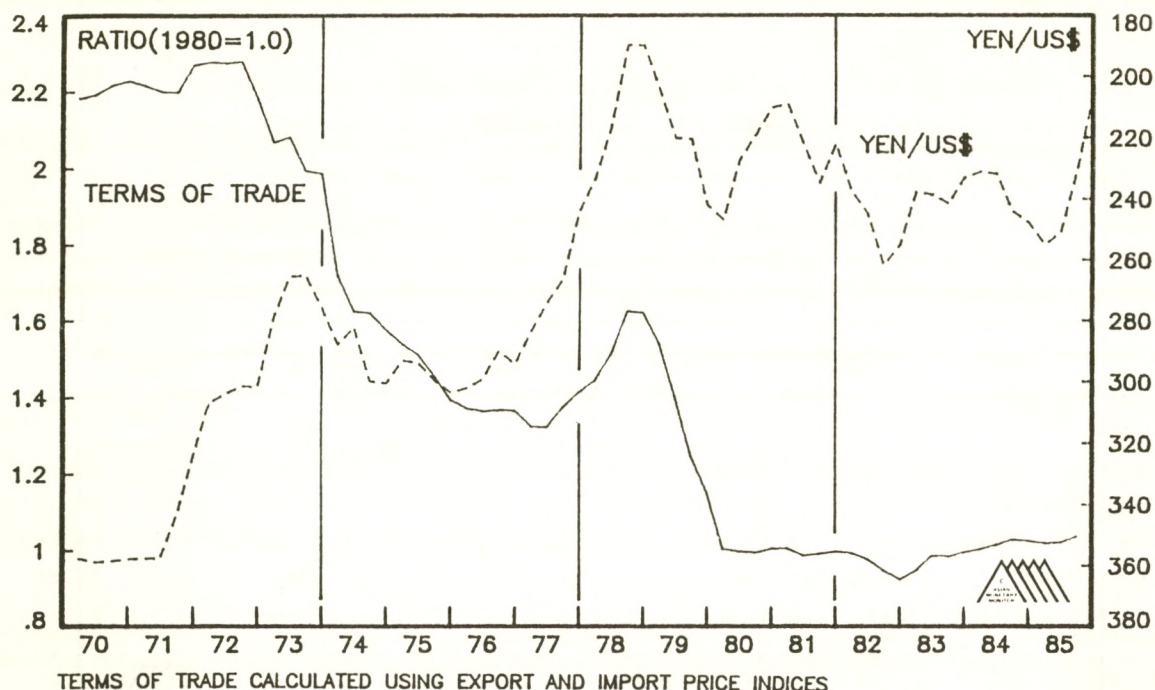
HK\$ MONEY GROWTH STABILISES AS LINK MATURES



The HK\$M1, HK\$M2 and HK\$M3 definitions of money exclude all foreign currency components, in an attempt to isolate the potential impact of monetary developments on the Hong Kong economy. Since October 1983, when the HK\$/US\$ link was adopted, money supply has behaved extremely erratically. HK\$M3 has ballooned, expanding at a rate of 22.2% per annum since October 1983, while HK\$M1 has recorded a similar growth rate of 21.6% per annum. HK\$M3 slowed to 14% year-on-year in November, suggesting that monetary growth is slowing, which may mean that the period of adjustment to the link and its attendant short term effects, is largely past.

Following the currency stabilisation, there was an upsurge in the willingness to hold Hong Kong dollar assets which raised the HK\$M3 and HK\$M2 monetary multipliers. The unwinding of swap positions due to the abolition of the tax on Hong Kong interest payments, also boosted HK\$M3 growth while the link's initial undervaluation of the HK\$ contributed further to the rapid growth of HK\$ money. However, slow growth in credit demand implies that the latter was little more than a temporary phenomenon associated with adjustment to a new base trend. Over the longer term monetary growth has to adjust to the external discipline of the balance of payments, which should avoid a repetition of the credit expansion of 1979-82. The eventual rate of monetary expansion will depend upon real growth within the economy, the price level and the demand for holdings of HK\$ balances. The downturn in exports from Hong Kong in 1985 must impact on growth prospects for 1986, implying a slowdown in real growth and hence a deceleration in the money supply compared to recent growth rates.

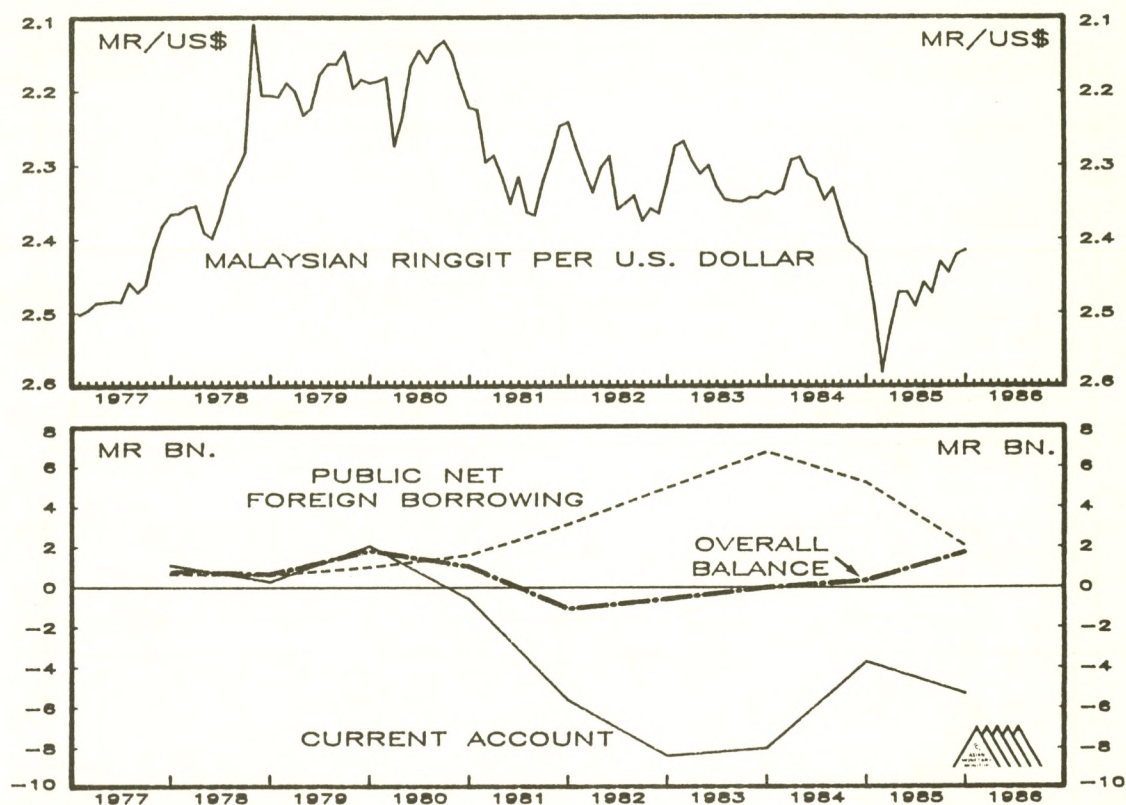
JAPAN'S TERMS OF TRADE SET TO IMPROVE



The terms of trade are defined as the ratio of export prices to import prices, both expressed in domestic currency terms. If a country's export prices rise relative to the prices of its imports, the terms of trade are said to have improved, implying that the country has to export less in order to pay for a given quantity of imports. The main influences on Japan's terms of trade over the past decade have been the two commodity price surges of 1973-75 and 1979-80. In 1973-74 Japanese import prices in yen rose more rapidly than export prices despite the appreciation of the yen from 1971 to 1973, hence the 42% decline in the terms of trade ratio from 2.28 in 1972 Q3 to 1.32 in 1977 Q2. In 1977-78 the 55% appreciation in the yen against the US\$ from 294 to 190 (quarterly data) helped to produce a 23% rise in the terms of trade from 1.32 in 1977 Q2 to 1.63 in 1978 Q3. (This was due to a faster fall in yen import prices than in yen export prices. Yen export prices declined steadily from 1974 to 1978; yen import prices rose slightly from 1975 to 1977, then plunged in 1978.) The second commodity price surge in 1978-79 produced a 38% deterioration in the terms of trade as the index declined from 1.62 in 1978 Q4 to 1.00 in 1980 Q1.

Since 1980 changes in the terms of trade have been comparatively mild. Between 1980 Q1 and 1982 Q4 there was an 8% deterioration (due mainly to a rise in import prices in late 1982 as the yen weakened), and between 1982 Q4 and 1985 Q3 there has been a 12% improvement (due to import prices falling more than export prices). With the recent appreciation of the yen, the terms of trade will improve as yen import prices decline. However, the improvement may not match the currency appreciation (compare the 55% yen appreciation in 1977-78 with the 23% improvement in the terms of trade): importers' margins will widen, while exporters' margins will shrink.

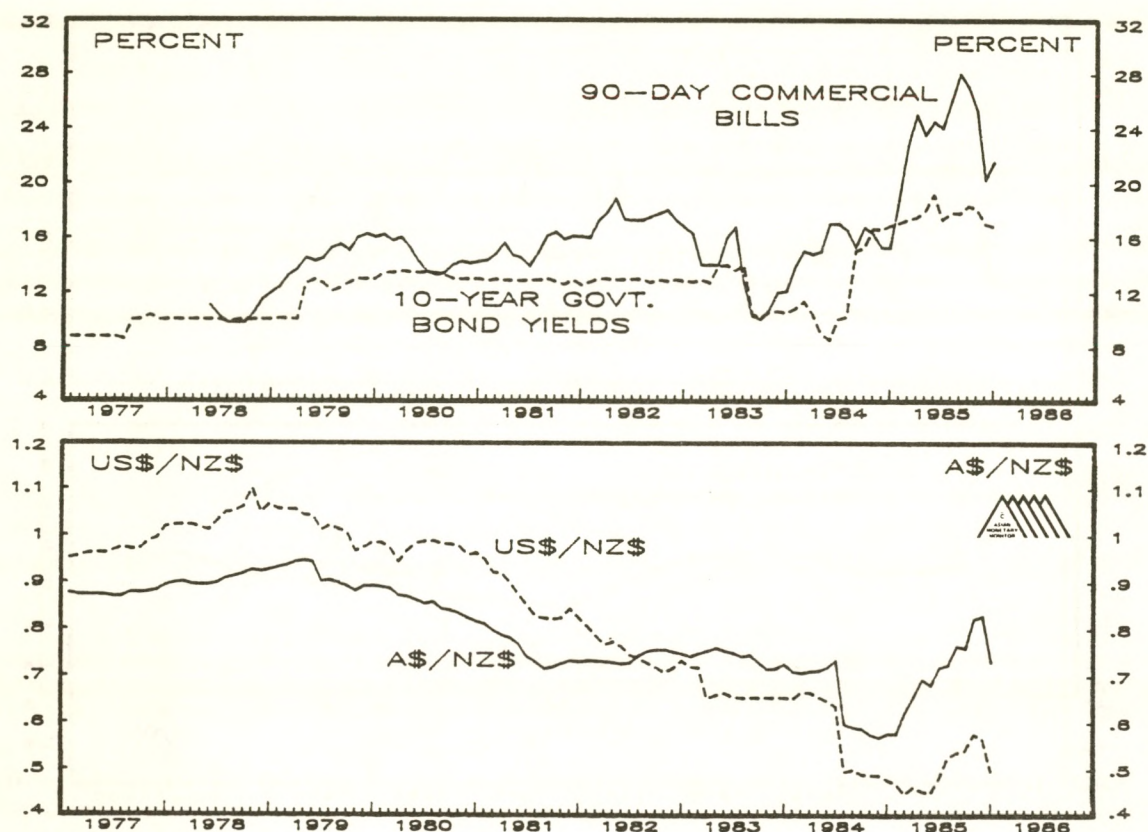
MALAYSIA: WEAK OIL PRICES THREATEN THE RINGGIT



Despite the weakness in commodity prices the Malaysian Ringgit has continued to remain very stable on the foreign exchanges, albeit with a tendency to drift downwards against the strong US dollar since 1980. Superficially the stability of the Ringgit results from Bank Negara Malaysia's (BNM) policy to closely manage the Malaysian currency with reference to the Singapore dollar. More fundamentally, however, the ability of BNM to maintain the Ringgit's comparative firmness to date reflects the stability of the overall balance of payments position, which has fluctuated only mildly over recent years, thus allowing BNM to maintain both a stable exchange rate and comparatively steady liquidity conditions in the economy.

Developments in the balance of payments can be seen as occurring in roughly three stages since commodity prices began a general decline in 1981. First in 1981-83 the balance of payments was supported by huge public sector overseas borrowings to finance development projects. Second, in 1984 there was a marked improvement in the current account reflecting a sharp increase in palm oil prices and hikes in oil output over 1983-84. Third, in 1985 there were large inflows from the repatriation of funds by Petronas, partly to finance the rescue of Bank Bumiputra. For 1986, with other options closed, the government has again had to turn to a sharp 18.6% rise in oil production to generate foreign exchange earnings, thus further increasing the dependence of the economy on oil. The Ministry of Finance has projected 1986 export earnings on the basis of an oil price of US\$26 per barrel and an exchange rate of US\$1 = M\$2.50. If the oil price averages significantly below this level (say, US\$20), then a devaluation of the Ringgit should be expected.

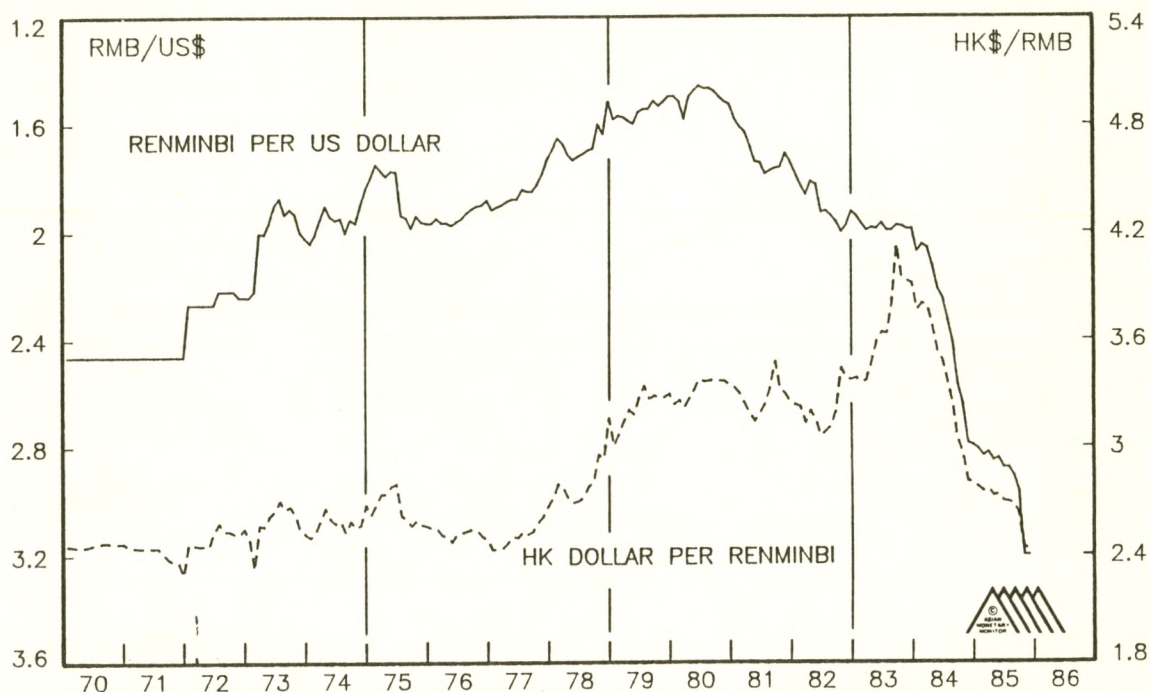
NEW ZEALAND DOLLAR LIABLE TO DEPRECIATE



Interest rate controls were abolished as soon as New Zealand's Labour government took office in July 1984, and the NZ\$ was simultaneously devalued by 20%. Subsequently a series of measures removed restrictions on financial institutions (e.g. ratio controls on balance sheets), and in December 1984 all controls on foreign exchange transactions were eliminated. Initially the NZ\$ floated upwards, rising against the A\$ from February 1985, and against the US\$ from May 1985, but since peaking in October at 59 US cents it has fallen back below 50 cents.

The strengthening and subsequent weakening of the NZ\$ appears to be closely related to the inversion of the yield curve. Thus with 90-day commercial bill rates standing as much as 8 percentage points above 10-year government bond yields between March and October the NZ\$ appreciated steadily. The policy of the New Zealand authorities has been to limit money growth through substantial sales of government securities at market interest rates. This, combined with 16% CPI inflation (due to price and wage de-control plus the effects of the 20% devaluation), and strong demand for funds forced interest rates in the private sector to extraordinary levels. The peak was in the period August-October, dramatised by overnight rates reaching 90% in the first week of October. High real interest rates and tight money initially attracted foreign investors, but now with economic growth slowing and the demand for funds falling, interest rates themselves have been falling over the past two months. The strength of the currency between March and October also threatened to undermine profitability in the farming sector, putting pressure on the government to ease up on its tight money policy. The next move in the NZ\$ will be downward.

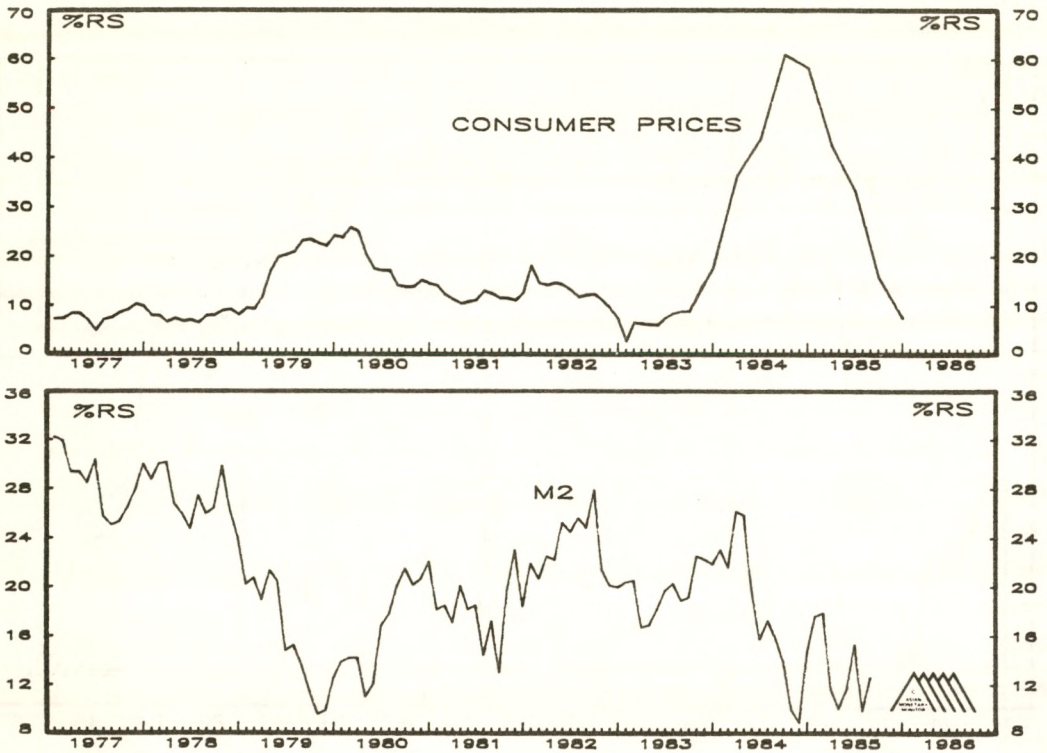
PRC's RISING PRICES SPELL RMB DEPRECIATION



Since mid-1980 the Chinese Renminbi (RMB) has depreciated by some 55% against the US\$, and by 38% over the past two years. Since the US\$ appreciated by 60% against a trade-weighted basket of currencies between 1980 and March 1985, some of the RMB's depreciation simply reflects the upward surge of the US\$. However, since the US\$ started to weaken in March the RMB has depreciated by a further 12% against the US\$. After years of relative firmness, why has the RMB suddenly become so weak?

The reason why the RMB was able to remain firm was that for years China suppressed inflation with price controls and maintained minimal trade relations with the outside world. Prices of domestic goods and services (including wages) were set by the state. However, since 1978 prices in the agricultural sector have been freed up, and since October 1984 industrial prices have also been allowed to rise. Simultaneously, trade with the outside world has expanded enormously so that prices in China are increasingly linked to prices abroad. As China's prices are adjusted upwards after years of controls, the currency must depreciate. A further twist is that China has adopted an unusual development strategy which by and large rejects the resort to foreign debt as a source of capital for development. The counterpart of this, in balance of payments terms, is that China must attempt to achieve a near-equilibrium in her balance of trade. Since 1984-85 saw a serious deterioration in China's trade balance (financed by running down reserves from US\$17.3 bn in September 1984 to US\$11.5 bn in June 1985), imports have had to be sharply curtailed and one method of doing this was to allow the currency to depreciate. If China is to liberalise prices further but refuses to finance its trade deficit through foreign borrowing, the RMB must almost certainly depreciate more in future.

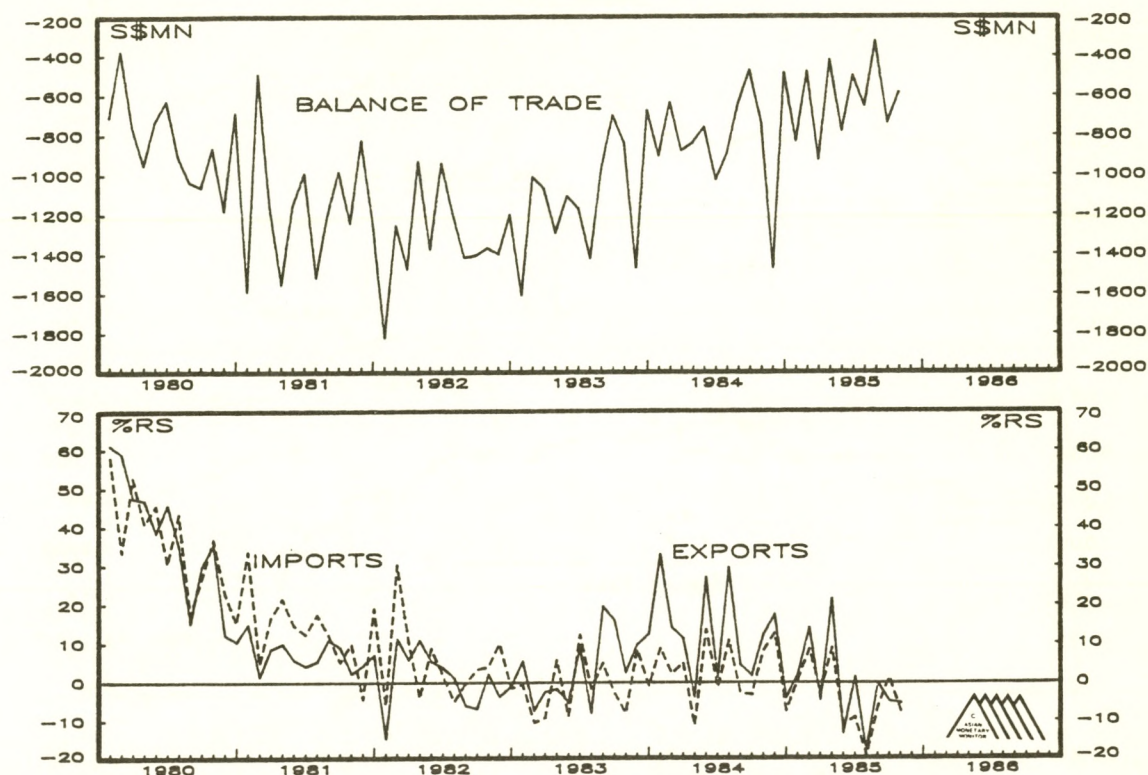
PHILIPPINES' INFLATION BACK INTO SINGLE DIGITS



The inflation rate in the Philippines plummeted during 1985, falling from 60% in late 1984 to 6% by December 1985. The fall in inflation followed a severe monetary contraction in 1984, during which the rate of money supply growth fell from 26% early in the year to single digits by November. The extreme tightness of liquidity accentuated the depression in the economy, which has seen real GNP contract by roughly 10% since the Philippines' debt crisis began in October 1983.

Hyper-inflationary conditions developed in the Philippines in 1982, with a huge expansion in the government's budget deficit to ₱14.4 bn. Although not extraordinarily high as a proportion of GNP (4.3%), the deficit was largely monetised because of the lack of financing options open to the government. In 1982 the monetary impact of deficit monetisation was largely offset by the loss of foreign reserves, but in 1983 with foreign reserves reduced to nothing and massive central bank lending to troubled financial institutions, the monetary base soared by 47.5%. Even a 5% hike in reserve requirements could not prevent this rate of monetary base expansion from translating into rapid growth in the money supply. By 1984, however, in an attempt to conform with IMF requirements the budget deficit had been halved, and 'overfunding' of the deficit via high yielding bonds and a further 1% hike in reserve requirements brought the rate of monetary growth down sharply. During 1985 banks' reserve positions eased substantially as the Philippines received disbursements of funds from the IMF and creditor banks. Continued weak money growth reflected a sharp fall in the monetary multiplier, attributable to the collapse of the economy, and severe financial problems at a number of banks. In October reserve requirements were actually cut but banks were expected to simply invest free reverses in high-yielding Central Bank bonds, thereby not expanding their balance sheets.

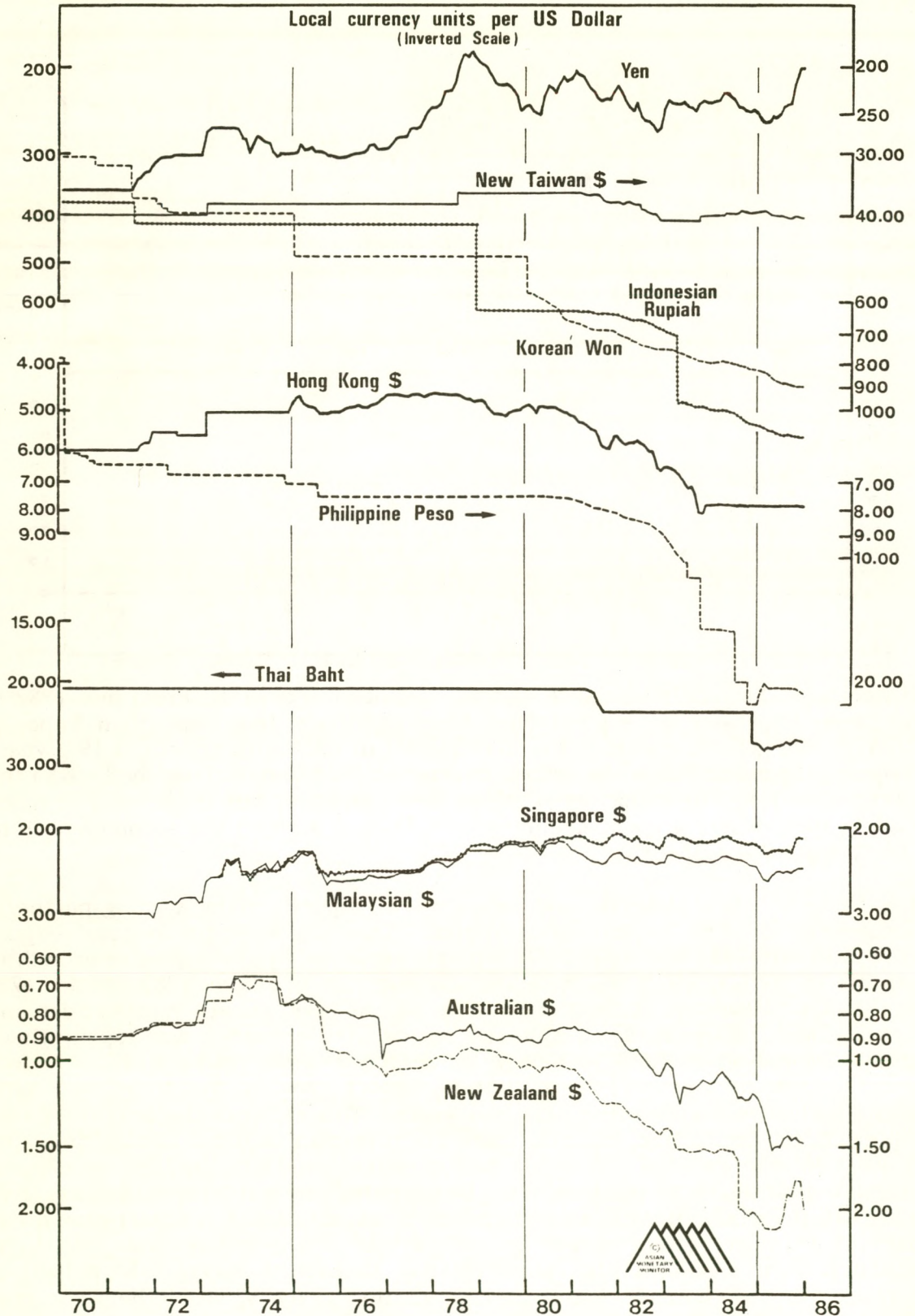
SINGAPORE'S TRADE BALANCE REFLECTS WEAK EXPORTS, BUT WEAKER IMPORTS



Historically, Singapore's balance of trade has been in deficit. From mid-1982 it has been improving as exports have been relatively less weak than imports. Total export growth peaked in the first quarter of 1984 with growth of 19% year-on-year, slipped to 2% in the second quarter of 1985 and declined by 8.4% in the next. The trend in import growth has been variable, but it has slowed more rapidly than export growth, declining by 4.3% and 9.3% in the second and third quarters of 1985 respectively.

The United States, Malaysia and Japan are Singapore's major trading partners, accounting for 49% of domestic exports. Thus the strength in total export growth in late 1983 and early 1984 is partly explained by the explosive growth in exports to the US, which rose to a year-on-year rate of 74% in 1983 Q4, and 67% in 1984 Q1. However, by the third quarter of last year, growth in export demand had declined from virtually every major source. The exception was Japan, where growth picked up to 3.6% year-on-year, despite a weak start to 1985. Import growth to some extent follows that of export growth, the trend becoming particularly obvious over the past two years. This reflects the import of raw materials for production, but also items for re-export included in total imports; if we take the case of chemicals and chemical products, in 1984 re-exports accounted for 36.5% of total imports. Despite this correlation it is inaccurate to attribute the whole of weak import growth to developments in export growth, as part of it must reflect slower growth within the economy and past tight liquidity. The weakness of imports relative to exports during 1985 helped to correct the trade balance, and some depreciation of the S\$ should help continue this trend, although a pick up in the domestic economy would be an offsetting influence.

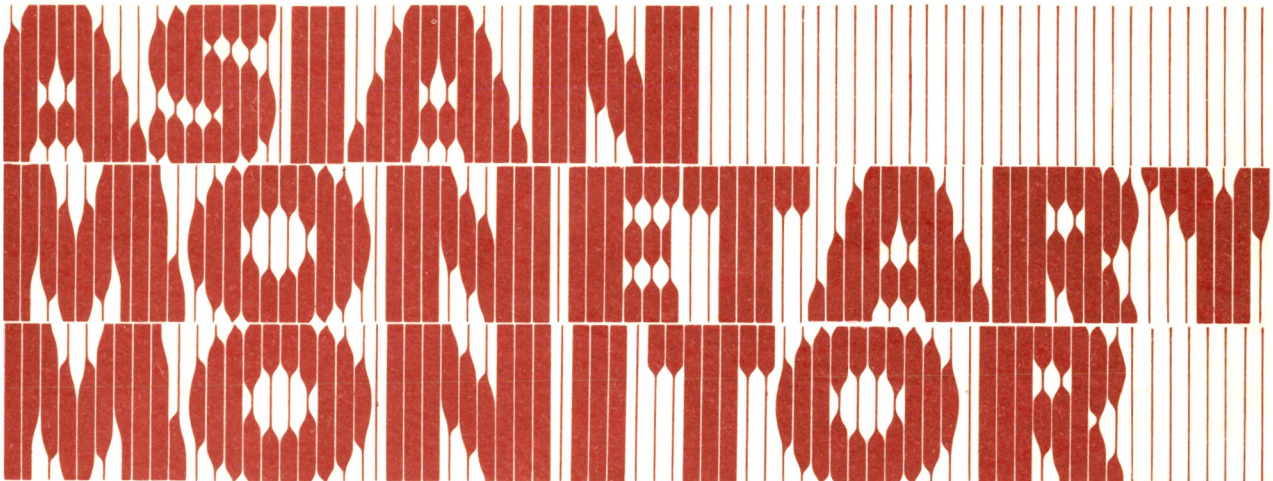
EXCHANGE RATES IN THE FAR EAST





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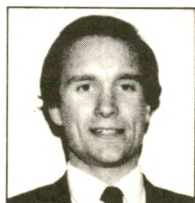
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KEYS TO SYMBOLS USED IN THE CHARTS

% RP	— Percentage Rate of change over Preceding period.
% RS	— Percentage Rate of change over Same period of preceding year.
SA	— Seasonally Adjusted.
SAAR	— Seasonally Adjusted at Annualised Rate.

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SPECIAL ARTICLE THE CRISIS IN GLOBAL AGRICULTURE

The present world-wide support system for agriculture is fast approaching a crisis. It seems only a matter of time before the realism which hit most commodity markets in 1981-82, then the tin market in late 1985, and more recently the oil market, hits agriculture - with the GATT meeting in July a likely flashpoint. This threatens major financial consequences: US farmers' indebtedness to their banks now exceeds the total of money owed to the banking system by Third World debtors, including the oil nations.

This paper estimates the size of the agricultural surplus problem and highlights the fragility of the present price-support systems. The oil and commodity slumps have had a profound impact on world financial markets. We attempt to hazard what the implications of a fall in agricultural prices would be.

World agricultural markets are in a state of serious imbalance with massive over-production financed by an increasingly querulous taxpayer. In spite of the existing high levels of subsidy many farmers, particularly in America, are in severe financial difficulty as the subsidies prove inadequate to cover the slide in export prices. Any further reductions in price or erosions in subsidy must aggravate these difficulties.

Figures for the global level of subsidy are not available but we estimate it at well in excess of US\$150 billion annually and suspect that the actual figure may well be much higher.

TABLE 1: ESTIMATES OF ANNUAL FARM SUBSIDIES (1985)

	<u>US\$ bn</u>
EEC:	15
USA:	19
Rest of Europe:	16
Japan:	??
Saudi Arabia:	3

Subsidies on this massive scale have encouraged overproduction, which in turn has been boosted by technological advances.

TABLE 2: INCREASES IN US AGRICULTURAL PRODUCTIVITY, 1915-1984

CROP	1915- 1919	1925- 1929	1935- 1939	1945- 1949	1955- 1959	1965- 1969	1980- 1984
Wheat bushels per acre hrs per 100 bbls	13.9 98	14.1 74	13.2 67	16.9 34	22.3 17	27.5 11	36.2 7
Corn bushels per acre hrs per 100 bbls	25.9 132	26.3 115	26.1 108	36.1 53	48.7 20	78.5 7	101.4 3
Cotton pounds per acre hours per bale	168 299	171 268	226 209	273 146	428 74	484 30	526 5
Soybeans bushels per acre hrs per 100 bbls	13.9 143	12.6 126	18.5 64	19.6 41	22.7 23	25.8 19	28.6 12

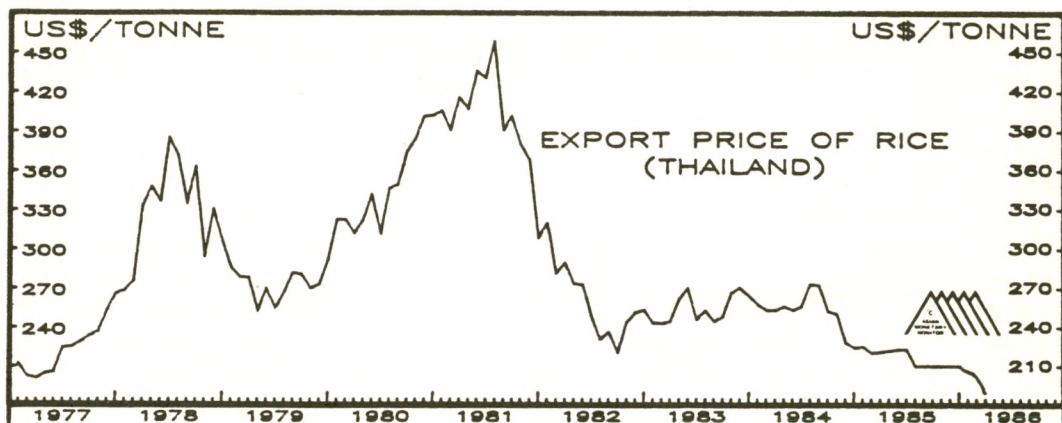
Source: Agricultural Statistics, US Dept. of Agriculture

It is possible to grow almost any product anywhere if enough governmental support is forthcoming, but taxpayers or consumers must bear the cost. For example farmers in Saudi Arabia were paid \$960 per ton for their wheat until 1984: in addition they were getting help with fertiliser, animal feed and the land was free. The wheat harvest rose an average of 60% p.a. from 1981 to 1985 and soon Saudi will have nearly half its wheat crop for export! The price was cut to \$550 per ton or four and a half times the world price in 1984, but production still exceeds demand. (1)

Domestic prices have not benefited from the technological improvements in production methods, but instead have been held artificially high by certain governments, leading to further increases in production and reduced or static consumption. The resultant surpluses have been dumped on world markets with the help of subsidies, further weakening world prices. Despite the substantial size of the subsidies, they have not been sufficient to maintain farm income particularly in the USA, resulting in a vicious downward spiral. Land prices are falling and banks are joining the farmers' lobbies; agricultural supply companies producing fertilisers, machinery, chemicals etc., and those trading in agricultural commodities are imploring governments to maintain their support for the farmer.

These vested interests, (and there are allegedly over 150 agricultural organisations lobbying in Brussels alone), exert continued pressure on governments to reinforce the price-support systems. While governments fight to preserve the universally accepted benefits of international trade the farming lobby has succeeded in spreading the myth that self-sufficiency in food production is in each nation's interest. Thus when President Reagan signed the new farm bills last year he said: "If things do not go well down on the farm, things cannot go well in our cities."

RICE CRISIS IN ASIA AS THE US DUMPS ITS GRAIN SURPLUS



In December 1985 the Reagan Administration decided to support US farm exports to the tune of US\$500 million per annum for three years starting in April 1986. Under the US Food Security Act of 1985 surplus US grains - wheat, corn, barley, and particularly rice - will be sold on world markets at whatever prices they can fetch, but US producers will be protected from the effects of this dumping by the Administration's support program. In the rice market the primary impact will be felt in Thailand, Burma and Indonesia - Asia's leading exporters.

The world faces a grain glut. Production in the Third World and elsewhere has soared in recent years just as population growth has slowed. Over the last two decades the high-yielding "miracle seeds" of the Green Revolution, improved pesticides, and cheaper fertilizers have helped double global grain production. Yet while China and South East Asia have become self-sufficient, the US and the EC have continued to try to sell roughly one third of their grain output abroad. In addition Australia and Argentina still sell the bulk of their crops overseas into the residual markets of Japan, the Soviet Union, the Middle East, Africa and Latin America. The result? A predicted global grain surplus for 1986 of some 300 million tons, over 50 million tons of which is rice.

The world price for top-grade Thai rice has crumbled from US\$480 per ton in 1981 to around US\$190 today, and will no doubt fall further. Thailand, the world's largest producer since 1982, and source of 40% of total world rice exports in 1984 has a population of 55 million, of whom over 25 million are rice-farming families. Despite rising production over the last four years, falling export prices have cut Thailand's export earnings from a peak of \$1.2 bn in 1981 to \$1 billion in 1984, and under \$1 bn in 1985. The Thai Board of Trade estimates that Thailand stands to lose 40% of its rice markets to the US during 1986 - almost 1 million tons out of exports of 2.3 million tons. The Thai situation is aggravated by the fact that the US will be dumping the same long-grained rice which Thailand cultivates.

Burma, which had planned to double its rice exports in 1986, has been forced to cut back, and may have to reschedule foreign loan repayments as a result. Indonesia's problem is similar to that of the US - a domestic surplus due to price supports at home designed originally to boost production during the years of shortages. Indonesia's Bulog, a government agency set up to buy, distribute and store grains customarily set an annual floor price to be paid to farmers for their rice. Predictably, as farmers have learned to rely on the government's fixed prices over the past few years, rice production has risen and with it Bulog's stockpiles, despite Indonesia's astonishing 2.2% p.a. population growth rate.

John Greenwood

In reality few, if any, products have no substitute and rarely is there no alternative supplier. America has kept Russia fed for years and, when she did try and cut off food supplies to punish Russia for invading Afghanistan, there was a queue of America's supposed allies, and Russia's supposed enemies, waiting to fill the gap.

Outside the Soviet block increased agricultural productivity is almost universal. China's average real income in rural areas arose about 17% p.a. between 1979 and 1983. Agricultural production increased over 7% p.a. during the last seven years and wheat production has risen over 10% p.a. since 1980, allowing wheat imports to fall from 13.7 million tons in 1980 to a projected 7 million in 1985/6. (2) This has been achieved by turning much of production over to the peasants and encouraging them with high prices which are then subsidised for the benefit of the city dwellers. Very recent reports however indicate that production has dropped back and agricultural policy may be altered.

India has changed from being a net importer of wheat to having occasional surpluses as wheat production has quadrupled since the 1960s. Some 70% of India's population work on the land, which gives them a strong hand electorally. (3) They pay no tax, their imports are heavily subsidised, and their produce is sold at guaranteed prices.

Against this the Soviet Union has seen production slide, its wheat output falling from 85m tons in 1982 to 76m in 1984. Ironically her agricultural failures have helped the West continue its profligate policies and partially avoid the consequences. Not only has Russia been a major buyer of grain from the USA, she has also helped to reduce the butter and beef mountains of the EEC at highly subsidised prices.

The notorious Common Agricultural Policy (CAP) of the European Economic Community may be responsible for much of the instability in world agriculture. The level of protection is high with price support policies for virtually every product. Effective rates of protection in 1977 were an average 158.1%, with wheat 194.7%; bovine meat 253.4%; preserved fruits and vegetables 161.7%; cheese 276.0%; butter at the astronomic level of 1322.7%, and levels have risen since. (4) The EEC's protectionist policies have depressed world market prices by increasing production, restraining consumption and using whatever export subsidies are necessary to dispose of the surpluses. This has effectively insulated the large EEC market, preventing it from absorbing variations in world supplies, while using the world market to absorb variations in EEC supplies at ever increasing cost to the taxpayer.

The Institute for Fiscal Studies in the UK estimated that in 1980/81 UK taxpayers' support for agriculture equalled 166% of net farm income (and that is not a misprint), and the Sunday Times (18.8.85) reckoned that the subsidy rate to mining the UK was less than 10% of turnover whilst that to the railways was about 33% and that to farmers was 40%.

Table 3 shows how EEC imports have fallen and exports have risen under these policies.

TABLE 3: EEC EXTERNAL TRADE IN SELECTED AGRICULTURAL PRODUCTS

<u>Product</u>		<u>Unit</u>	<u>1973</u>	<u>1983</u>
Wheat	Imports	Mt	7.4	3.9
	Exports	Mt	7.4	15.4
Other cereals (excl rice)				
	Imports	Mt	17.7	7.0
	Exports	Mt	6.9	7.5
Sugar	Imports	Mt	2.2	1.5
	Exports	Mt	1.1	4.1
Butter	Imports	kt	155.0	105.0
	Exports	kt	359.0	355.0
Cheese	Imports	kt	116.0	100.0
	Exports	kt	157.0	392.0
Beef & Veal				
	Imports	kt	1.080	435.0
	Exports	kt	167.0	600.0

Source: (5); Mt = million tonnes; kt = thousand tonnes

The CAP consumes over two-thirds of the EEC budget, adding more than Pds.7 per week to the food bill of a family of four. Costs to the EEC taxpayer have been estimated at Pds 20 bn pa with another Pds.20 bn spent on national agricultural aids. (6) The cost of export restitutions and other intervention measures rose from 2.329m ecu in 1972 to Pds.18.40m in 1984.

The full figures for EEC intervention measures are as follows:

TABLE 4: TOTAL GUARANTEE SECTION EXPENDITURE
Million ecu.

1971	1.5	1978	8.657
1972	2.329	1979	10.424
1973	3.927	1980	11.292
1974	3.094	1981	10.952
1975	4.512	1982	12.372
1976	5.576	1983	15.920
1977	6.822	1984	18.401

Source: Agricultural Policies in the EC p. 103, (7)

CHART 1
EC AGRICULTURAL SUPPORT EXPENDITURE
IN RELATION TO SPENDING CEILING

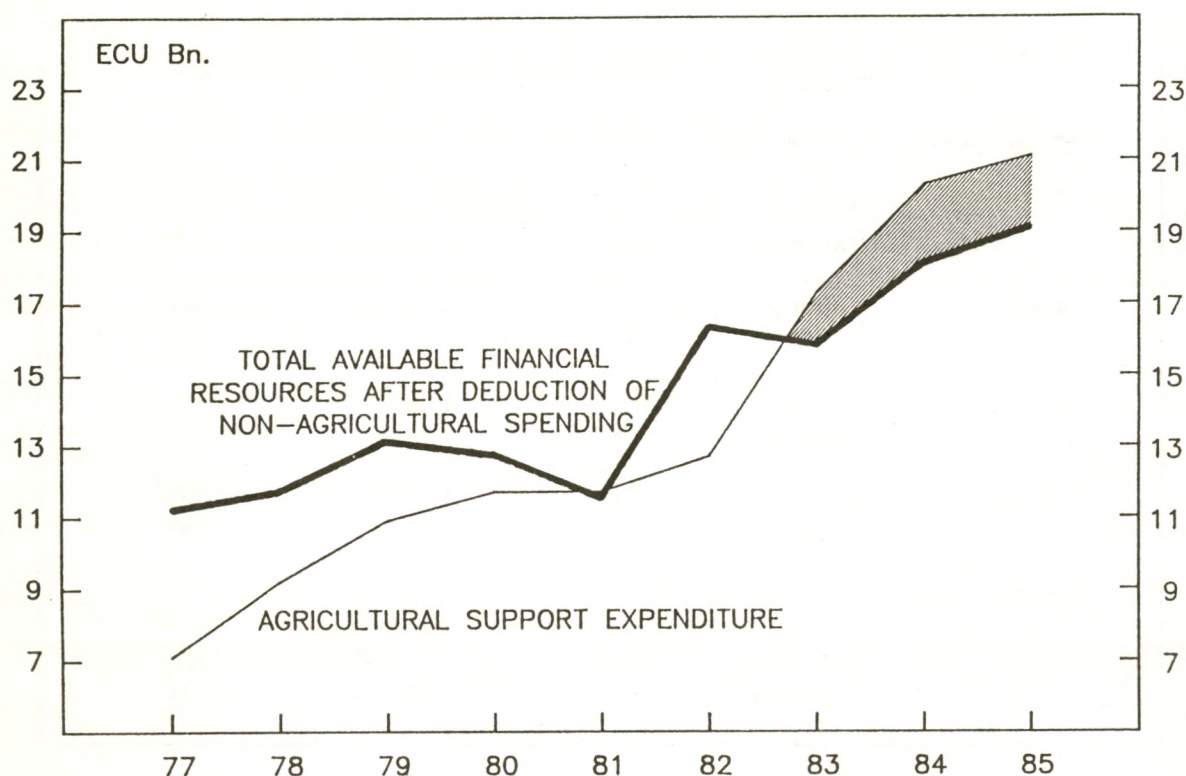


Chart 1 illustrates the pressure that this policy is putting on EEC budget.

EEC policies have simultaneously had a particularly devastating effect on the economies of traditional exporters of agricultural produce such as Argentina, New Zealand, Canada and Australia which have been powerless to protect themselves as agriculture constitutes such a major part of their economies. They have had similar effects in the USA, but America is strong enough to retaliate and is now beginning to do so.

A number of South American countries also rely heavily on agricultural exports. The Uruguayan economy, for example, has been devastated by the virtual banning of her beef exports to Europe and the competition it meets in other world markets from dumped European produce. Argentina is an efficient, low cost and expanding wheat exporter forced to sell her production annually, because of limited storage and a chronic foreign exchange problem, at whatever prices she can get.

Australia provides a classic example of the effect of EEC policies on the farming and agricultural export trade of a traditional producer. Table 5 shows the drastic declines in specific Australian exports to the EEC since the late 1960s.

TABLE 5: AUSTRALIAN EXPORTS OF SELECTED PRODUCTS TO THE EEC

(Unit: kt)	<u>1967-68</u>	<u>1982-83</u>
Beef & Veal	25.7	8.9
Barley	7.0	0.0
Sugar	400.0	0.0
Butter	57.1	0.3
Cheese	18.5	3.1
Apples & Pears	119.4	10.1
Canned Deciduous Fruit	123.0	29.7

Source: (8)

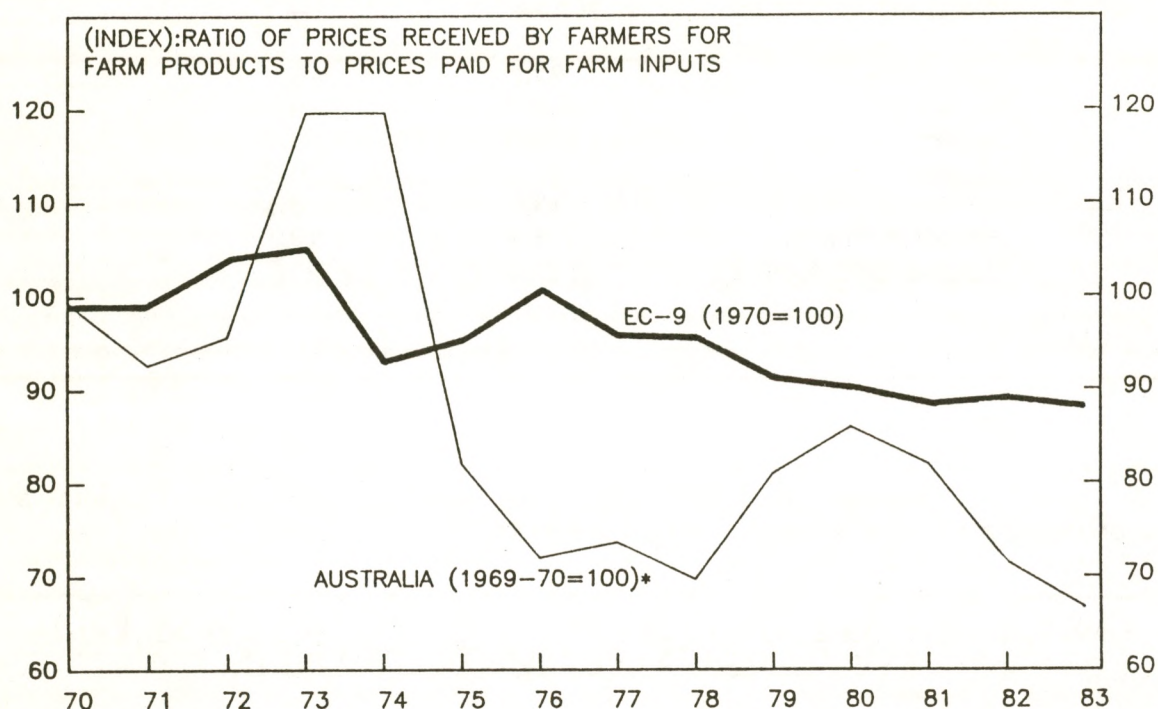
Table 6 contrasts rising EEC and falling Australian agricultural exports as a proportion of world trade in certain products.

TABLE 6: EEC & AUSTRALIAN NET TRADE AS A PERCENTAGE OF TOTAL WORLD EXPORTS FOR SELECTED PRODUCTS

<u>Commodity</u>		<u>1973-75</u>	<u>1981-83</u>
Wheat	EEC	+0.9%	+11.2%
	Australia	+11.3%	+10.6%
Other cereals			
	EEC	-10.8%	-1.8%
	Australia	+3.0%	+2.9%
Sugar	EEC	-4.1%	+13.1%
	Australia	+8.5%	+8.3%
Butter	EEC	+4.8%	+38.5%
	Australia	+11.0%	+2.2%
Cheese	EEC	+15.1%	+33.1%
	Australia	+5.6%	+4.3%
Beef & Veal	EEC	-12.3%	+6.2%
	Australia	+24.3%	+19.8%

Source: (9)

CHART 2
FARMERS' TERMS OF TRADE IN EC-9 AND AUSTRALIA



* FOR FINANCIAL YEAR ENDED 30 JUNE OF YEAR SHOWN

Chart 2 shows how Australian producers have suffered from the effect of improving technology and fairly static consumption whilst EEC producers have been shielded from them.

New Zealand's agriculture is export oriented and only partly subsidised. Farm incomes were thought to be in a critical position in 1984 but have since fallen by some 30% in 1985, while interest rates have risen from about 15% in 1984 to between 25-30% in 1985. Some 5000 of New Zealand's 76,000 farms are said to up for sale at prices 30% to 50% below the levels of 3 years ago. (10)

The USA has spent heavily on help for its farmers but not enough to enable them to compete equally with their subsidised European counterparts and their exports have been declining (see Chart 3). North American wheat production fell from 102m tons in 1982 to an estimated 92m in 1984 whilst that of Western Europe rose from 74m to 94m tons during the same period. It has been estimated that American farmers lost \$2bn p.a. because of EEC wheat subsidies. (11)

Many American farmers borrowed heavily to buy land or expand in the late 1970s, encouraged by strong demand from Russia and China and by the USAs rising share of the agricultural export market which stood at 49% but is expected to be down to 33% in 1985/6. As falling returns drive land prices down, many farmers can no longer service or repay their debts (see Chart 4). The Federal Farm Credit system holds about \$214bn farm debt and \$11.1bn of this is now thought to be uncollectable.

CHART 3

THE US IS RAPIDLY LOSING MARKET SHARE IN WHEAT EXPORTS

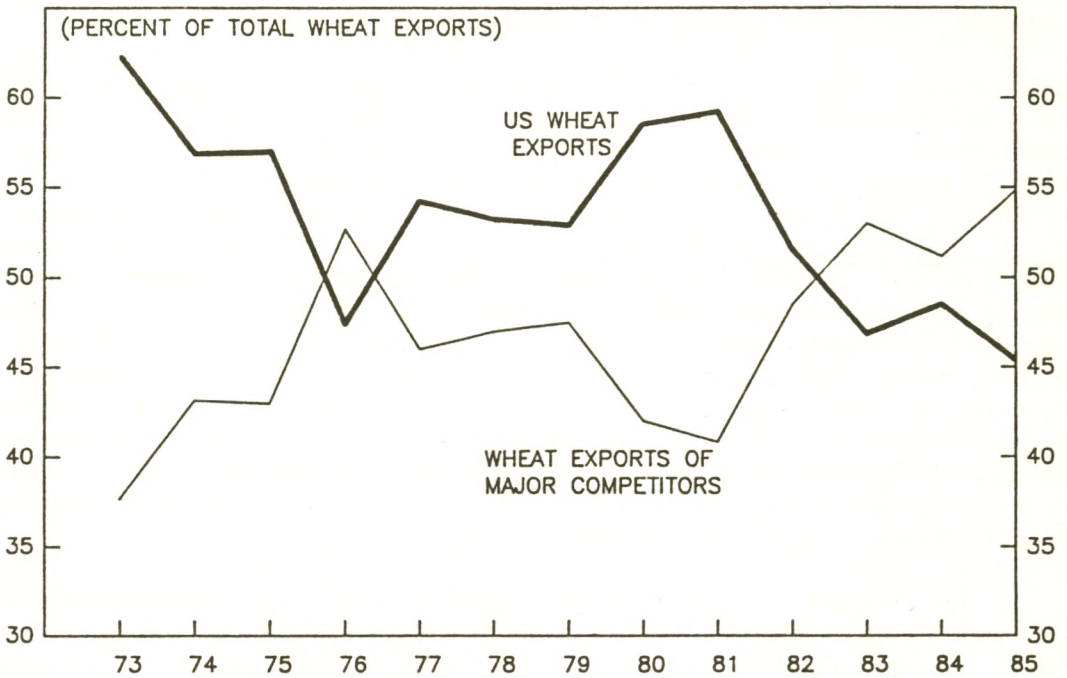
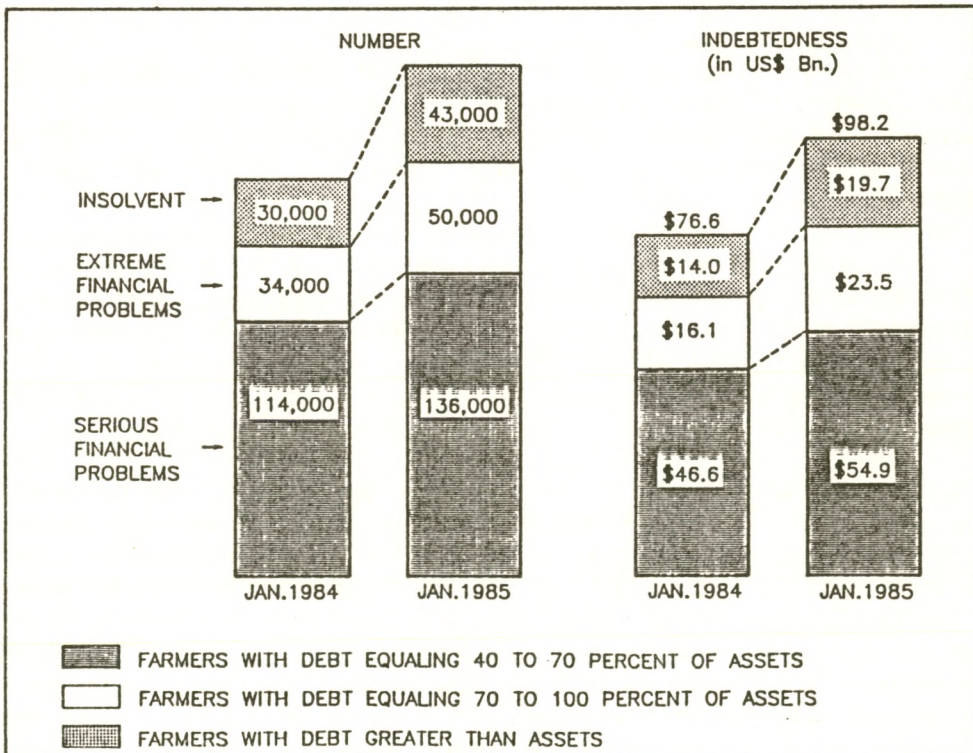


CHART 4

RIISING DEBT-LOAD OF U.S. FARMERS



SOURCE: AGRICULTURAL OUTLOOK, ECONOMIC RESEARCH SERVICE, USDA.

These are the sorts of figures which made the Reagan administration reconsider its threats to force its farmers to become more market oriented in 1986. Instead, in a volte face, the administration has agreed the most expensive package of agricultural support ever at \$53bn over three years.

America's determination to protect her farmers from EEC policies must exert further downward pressure on world market prices, pushing up the cost of support policies in the EEC. The EEC in turn will either have to increase its income by raising the percentage of VAT it takes from member states or cut the cost of its CAP by reducing surpluses. The cut could be achieved either by reducing support prices or imposing production quotas. The EEC had originally intended to cut or hold prices but this was blocked by the adamant opposition of Germany. (While Germany bears the greatest part of the cost of the CAP, the present German government depends on a coalition, which in turn depends on Bavarian politics where the farming vote is important.) An increase in the percentage of VAT taken by the EEC would have to be ratified in national parliaments which, given the universal struggle for tighter control of government spending, will be avoided if possible: so disguised price cuts may be the answer. Whether they will be big enough to have much effect on the surpluses, which are 15%-20% of annual production, seems unlikely.

In the absence of international cooperation an escalating international trade war in agricultural products, which could spread to non-agricultural sectors, appears probable. The USA has previously tried to solve the problem through GATT, but agricultural products are only loosely covered, and so far the EEC has managed to avoid action. This year may be different as several countries are preparing cases to support the claim that normal GATT rules should be applied to agricultural products. This could force national and EEC governments to rethink agricultural policies.

An end to highly protectionist agricultural policies would produce great long term benefits in terms of lower food prices and lower taxes. But in the short term either alternative - a trade war or lower subsidies - is ruinous both for farmers who have bought land at higher prices and for the institutions which have financed them.

It is impossible to forecast at this stage just how the present situation will be resolved, what is certain is that it cannot continue indefinitely. The consequences for the world financial system depend both on the magnitude and on the speed of change. If the transition to a freer market is gentle, the consequences could almost certainly be contained. But if there were a sudden collapse....

Agricultural debt seems to hang like an unexploded time bomb over the financial markets. Like oil or tin, the markets for some agricultural products are both homogenous and highly political, and the denouement could come unexpectedly quickly. Nevertheless the solutions are likely to be piecemeal, partly because quotas, tariffs and other administrative barriers have kept the markets for agricultural products strictly compartmentalised. Also the burden of indebtedness is different in different countries. For example in the United States farmers themselves have been put directly on risk via loans extended through the banking system with only small Federal guarantees whereas in the

EC farmers have been kept comfortably in the black via a complex system of subsidies ultimately financed by the ordinary taxpayer. Hence in Europe the burden on the taxpayer is much more remote than the direct accountability of the US banker to his stockholders. Thus the collapse of current farm subsidy systems could have a serious impact on the banking system in the US, but probably not in Europe. In the U.K. there is some exposure of financial institutions, pension funds and other organisations to farm land and agricultural property in general, but this is not such as to create a major financial crisis in the City of London. All in all the time bomb of agricultural debt looks more like a Chinese firecracker - a device which will lead to a series of small explosions one after another in different places, rather than a single big-bang type of solution.

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JAPAN

THE MAKINGS OF A RESURGENCE IN THE DOMESTIC ECONOMY

In the wake of the sharp appreciation of the yen - which rose by 37% against the dollar between mid-September and end February - forecasts of Japan's growth prospects have been universally gloomy. Not only are exports being hard hit by the yen's rise, but investment spending is also expected to weaken markedly as a result of the diminished export prospects. A recent survey of 1,815 major companies by Japan Development Bank indicated a slowdown in the growth of corporate capital investment to only 1.6% in fiscal 1986 from the expected 9.2% growth in fiscal 1985, largely as a result of a sharp fall off in manufacturing investment. It must be assumed unlikely that the yen will fall back to its pre - G-5 level anytime soon and with growing international pressure on Japan to reduce its burgeoning trade surplus it is evident that Japan will, in the future, be unable to rely upon exports as the engine of economic growth to the extent that it has in the past. Thus it is increasingly apparent that if Japan's economic growth is to be sustained at anything approaching historic rates, then Japan must switch from being a primarily externally oriented economy to being a primarily domestically oriented one i.e. in future the growth of the economy must be generated primarily from growing consumption of domestically produced goods and services and investment in the production of those goods and services, as opposed to investment in production for export. If the Japanese economy was able to undergo successfully this metamorphosis it would clearly produce major benefits for the Pacific Basin area and have major implications for the world economy as a whole. This article explores briefly the broad issues involved in domestically driven economic growth, in particular drawing the distinction between the factors affecting the cyclical trend in the domestic economy and those affecting the secular trend.

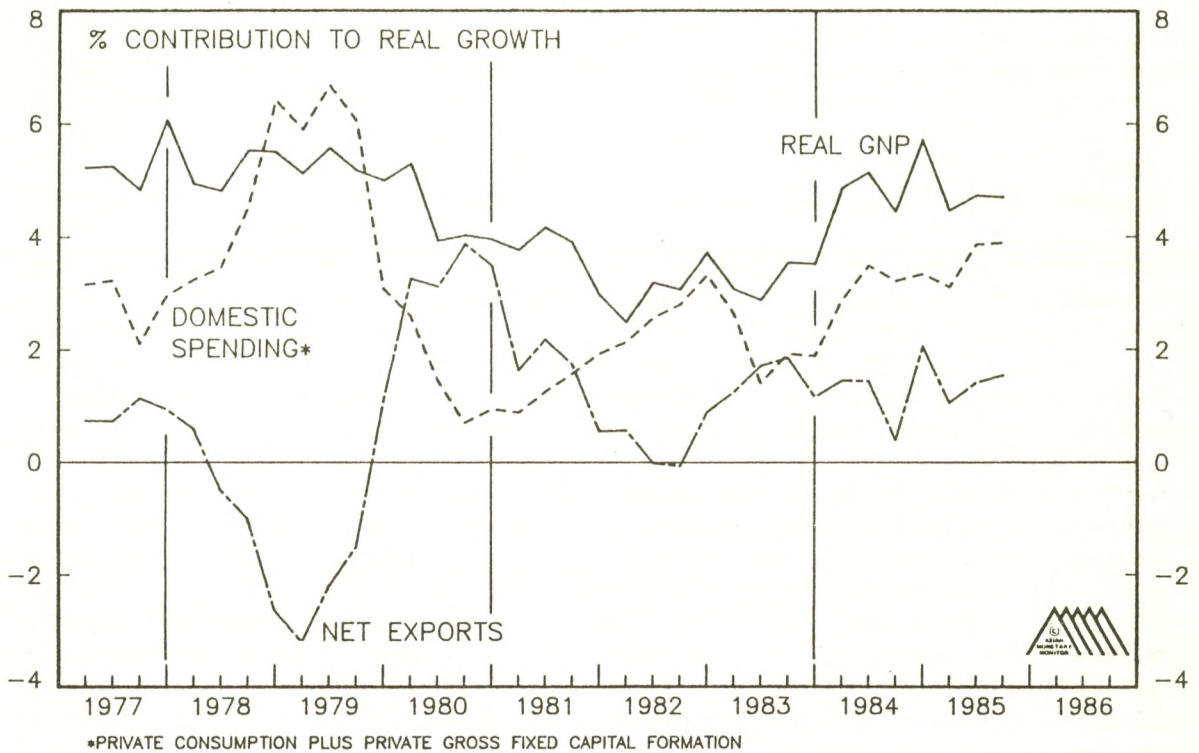
In a cyclical sense, the domestic component of Japanese economic growth is certain to pick-up over the next year in the wake of both the yen's sharp appreciation and the collapse in oil prices. This is best illustrated with reference to the Japanese experience in 1978, after the yen rose by 60% against the dollar from late 1976 to late 1978, as shown in Chart 1.

Chart 1 makes use of the familiar expenditure identity for national income $Y \equiv C + I + G + (X - M)$, where Y = the GNP, or national income, C = private consumption, I = private investment, G = government spending, X = exports and M = imports. On the chart the growth in GNP is split into the contribution from private domestic spending i.e. $C + I$ and the contribution from the trade account i.e. $X - M$. Private domestic spending here is therefore defined to include spending on imports. An alternative way to view the 'domestic component' of economic growth would be to consider only private domestic spending on domestic output, i.e. $C + I - M$, leaving the external component defined as being only exports, (i.e. foreign spending on domestic output) rather than the overall trade balance.

The marked cyclical improvement in the domestic component of economic growth in 1978, subsequent to the sharp appreciation of the yen over 1976-78

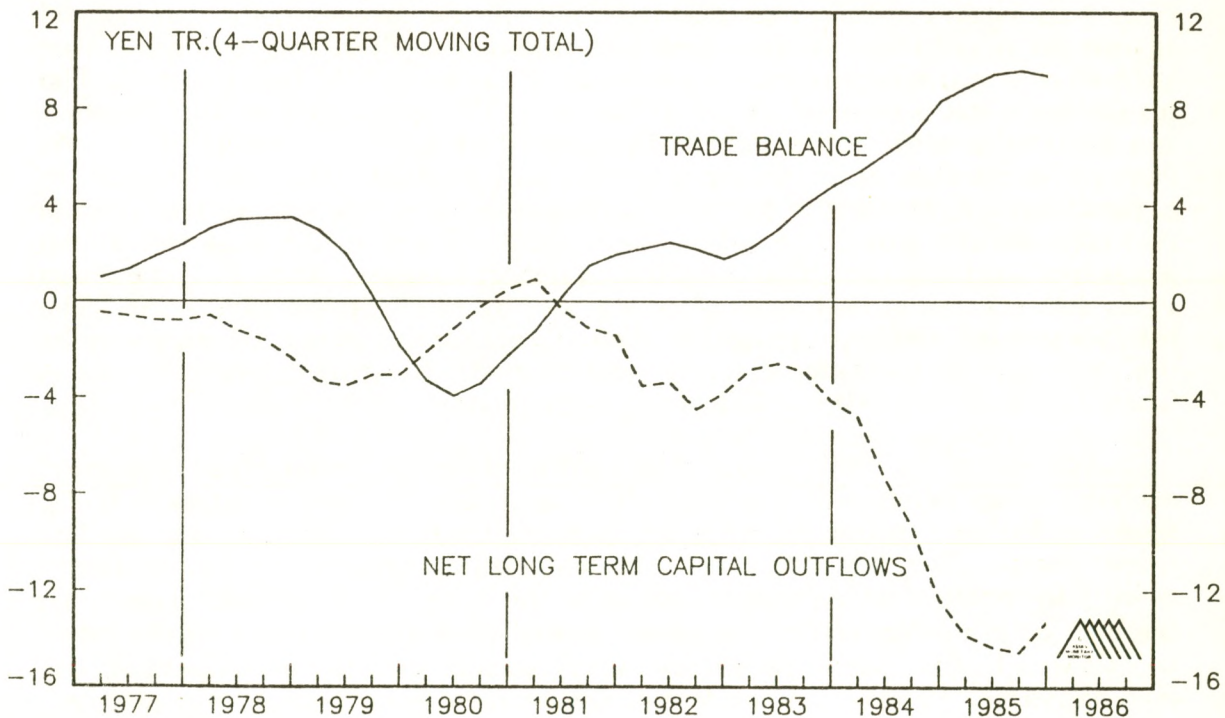
JAPAN: CHART 1

THE COMPONENTS OF ECONOMIC GROWTH



JAPAN: CHART 2

TRADE AND CAPITAL ACCOUNTS OF THE BALANCE OF PAYMENTS



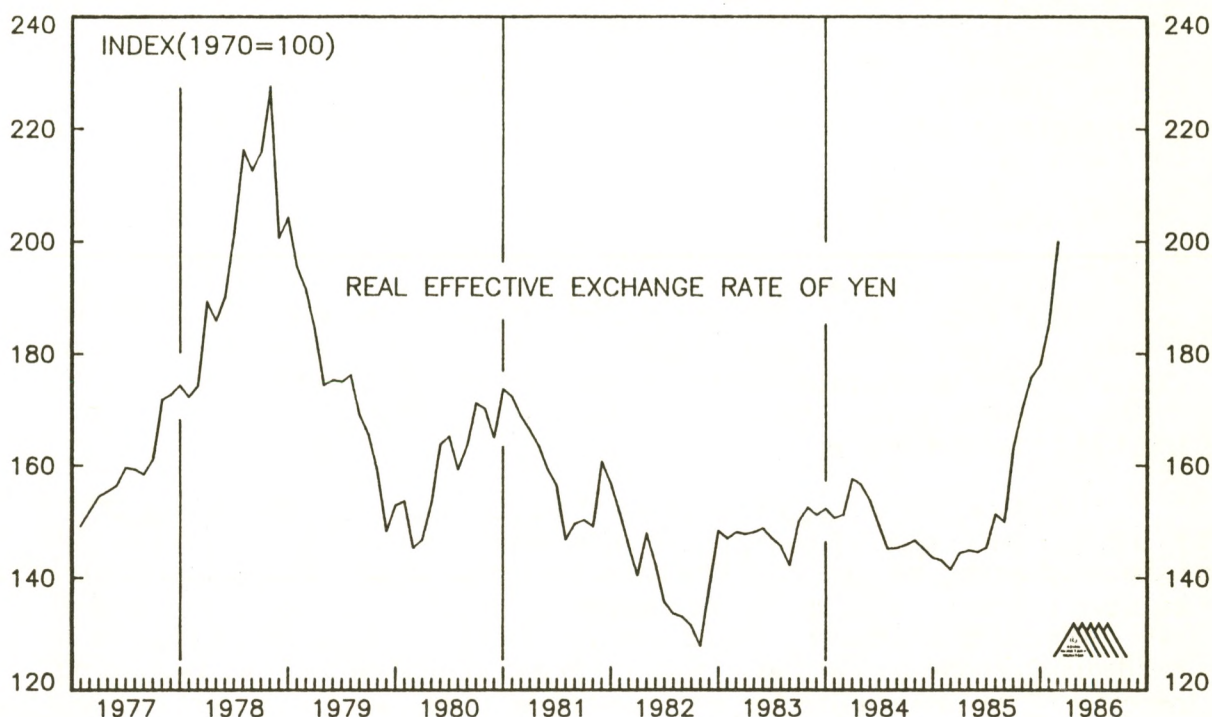
(shown in Chart 3 on a real effective exchange rate basis) is clearly visible on Chart 1. An appreciation of the yen means that imports, demand for which is comparatively price inelastic, become cheaper in yen terms. Revenues from exports, however, do not fall by as much initially because prices, in yen terms, are comparatively rigid and demand is comparatively price inelastic in the short term. Hence, as a result of this 'terms of trade' effect of the yen appreciation, the trade account initially improves in nominal terms (but not in real, or volume, terms, in which it tends to deteriorate) and hence Japan enjoys a 'one-off' increase in nominal national income. Income can only be spent on consumption, saved or taxed (i.e. $Y \equiv C + S + T$, where C is consumption, S savings and T taxation) and therefore at least part of the increase in nominal national income translates into an increase in nominal consumption spending. However, unlike the increase in the trade surplus, the increase in consumption represents an increase in real terms because there is no corresponding increase in the price level. In fact, inflation is likely to fall initially as a result of the fall in import prices. Thus the pattern develops as in 1978 whereby the domestic component of real economic growth improves while the real external component deteriorates, even though the trade surplus in nominal terms increases. In 1978 private consumption growth in nominal terms in Japan fell from 11.2% in 1977 to 9.6%, roughly the same as the respective growth rates of nominal GNP in the two years. In real terms, however, consumption growth rose to 4.7%, from 3.8% in 1977, and rose further in 1979, to 6.5%. For the external component imports showed quite strong growth, of 6.5%, in real terms in 1978, leading to a deterioration in the 'real' trade surplus in the national accounts as indicated by Chart 1. In nominal terms, however, imports fell sharply by 9.4%, leading to the improvement in the 'nominal' trade surplus shown in Chart 2.

Japan's 1978-79 experience was brought to an abrupt end by the second oil price shock. The sharply higher import prices resulting from the more than doubling of oil prices over 1979-80 on its own represented a loss of national income to Japan equivalent to roughly US\$30 bn. Furthermore, the yen plunged against the major international currencies, wiping out all of the yen's gains over 1977-78 on a real effective exchange rate basis, by early 1980 (see Chart 3). The result was a sharp reversal of the 1978-early 1979 cycle, as shown in Charts 1 and 2. The nominal trade surplus disappeared by 1980 as a result of an 85% increase in nominal imports over the two years 1979-80. The resultant loss to national income, allied with higher inflation, translated into a sharp reduction in real consumption growth, to only 1.4% in 1980. However, the weakness of the yen helped lead to an eventual reduction in import volumes, which fell by 6.2% in 1980, and a surge in real exports, which rose by 17.7% in the same year. The result was a marked improvement in the external surplus in real terms, shown by the sharp rise in the external component of real GNP growth over 1979-80 in Chart 1, even as the external balance in nominal terms deteriorated (Chart 2).

Subsequent to 1980, Japan has continued to be an externally oriented economy to an extent which is not obvious from Chart 1, where net exports are shown as having contributed under 2% to overall economic growth over the last three years. The key point here is that while consumption has remained essentially weak, showing annual growth in the 2.5%-3% range since late 1983, the pick up in the 'domestic component' of real GNP growth over 1984-85 shown on Chart 1 has been paced by very strong growth in investment in manufacturing. Private non-residential gross fixed capital formation grew by a

JAPAN: CHART 3

THE REAL EFFECTIVE EXCHANGE RATE OF JAPANESE YEN



very strong 10.9% in real terms in 1984 and accelerated to a year-on-year growth rate of 13.3% by the third quarter of 1985. This investment has been largely in manufacturing and largely in the export industries, and relates to Japan's growing exports reflected in the continuous rise in the trade surplus on Chart 2, and the continuous positive growth in real net exports indicated by Chart 1. Thus although this investment is 'domestic' spending it depends entirely upon the performance of external spending, and hence should be more properly viewed as part of the external sector of the economy. Hence the widespread concern about the trend in investment spending in view of the likely decline in exports, noted in the first paragraph.

The secular reasons why the external orientation of the Japanese economy has become more pronounced even as the economy has grown to a size equivalent to 40% of the US economy relate primarily to the uses to which Japan's huge pool of savings has been put. Other than in the financing of government spending a country's savings can only be invested in three broad ways - in investment in domestic production to satisfy domestic demand, or investment in domestic production to satisfy external demand, or invested overseas. In Japan's case the returns available on the first type of investment - in production for domestic demand - have been to a degree depressed by legislative constraints, notably in the financial sector and also in other sectors of the economy. However, since 1981, the returns on investment available overseas have been high as strong growth in private investment and also in government deficits overseas, particularly in the US, have given rise to a growing world demand for savings. The consequent uptrend in long term capital outflows from Japan - shown in Chart 2 - in depressing the yen, altered relative prices such as to further raise

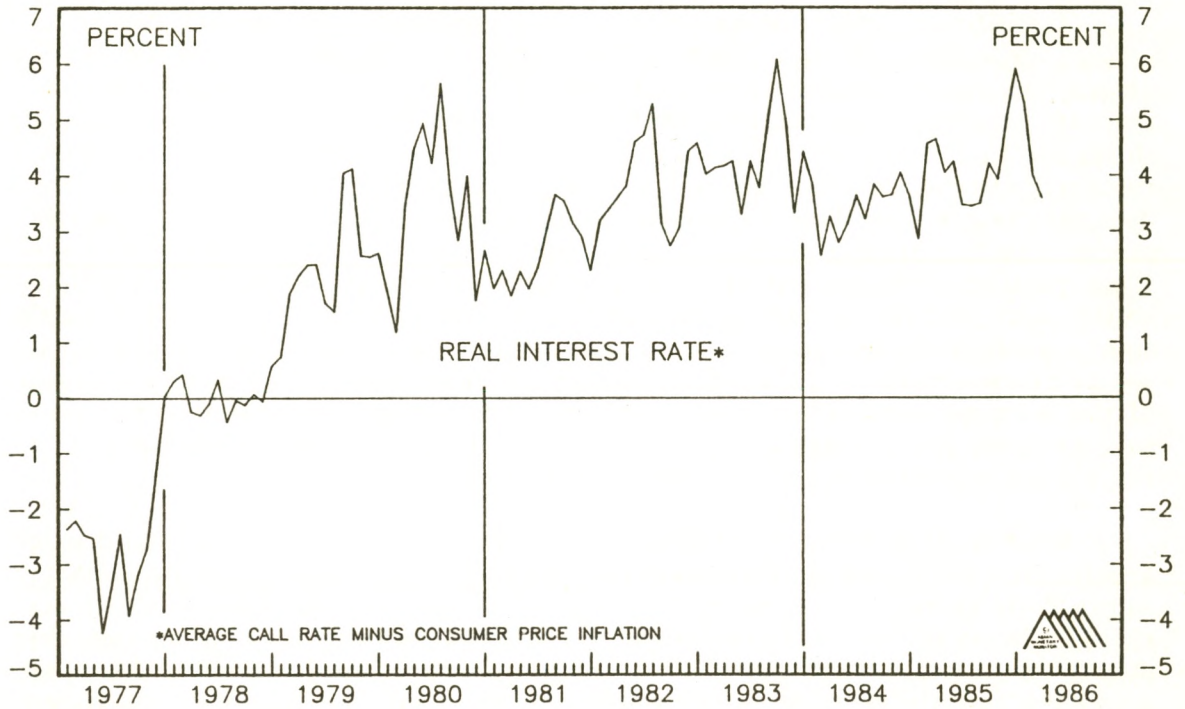
the returns on investment in production for export relative to the returns available to investment in production for domestic demand, within the domestic economy. The response of the Japanese monetary authorities to currency weakness - in generally following a tighter monetary policy than justified by domestic economic conditions in order to prevent the yen from weakening even further - probably had the effect of depressing domestic demand and investment in the domestic sector of the economy further, thus exacerbating and extending the trend.

As Chart 2 indicates, little has changed in the net long term capital outflow picture to suggest in itself any significant change in underlying economic trends. Although the chart does show a slight apparent improvement in the long term capital account in the final quarter of 1985, this only reflects the currency translation effect of the sharply higher yen. In US dollar terms the long term capital account deteriorated further in the fourth quarter, as did the short term capital account, leaving the overall balance of payments in a large deficit of US\$3.23 bn for the quarter.

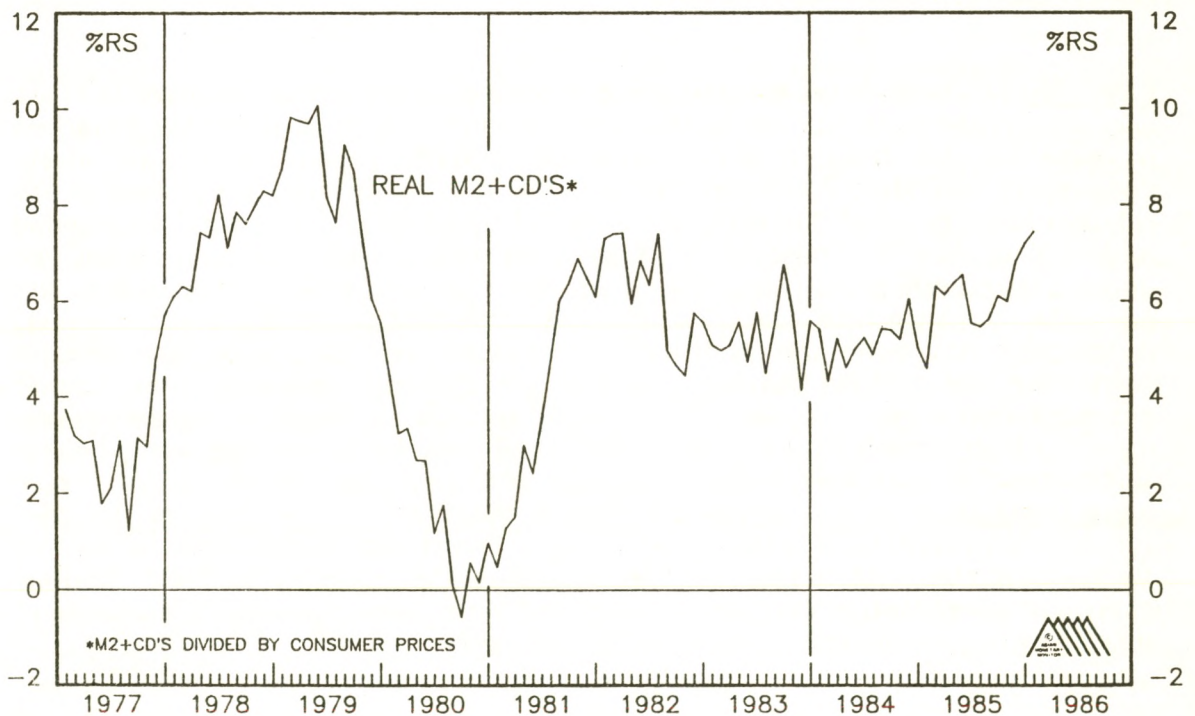
Therefore, the yen appreciated by 17% against the US dollar during 1985's fourth quarter in spite of a continuing underlying deterioration in Japan's overall balance of payments position. The balance of payments measures transactions between residents of Japan and non-residents, while the yen/US dollar exchange rate reflects the relative demand for yen assets vis-a-vis yen liabilities of residents and non-residents, as well as trade and capital flows. The two are not necessarily the same thing because non-residents of Japan can increase their gross yen assets and liabilities (although not their net position) by transactions between themselves (e.g. in the forward foreign exchange market) and possibly move the exchange rate without involving residents of Japan. However, the recent sharp improvement in the yen probably also relates to short term capital inflows not included in the balance of payments statistics, specifically those involving the borrowing of US dollars by Japanese institutions for the hedging of the exchange rate risk associated with investment in US securities. Such hedging would have the effect of weakening the US dollar vis-a-vis the yen because the institutions would sell the borrowed US dollars for yen in order to create a net US dollar liability to match the US dollar asset represented by the US security. Either way it is clear that the sharp rise in the yen has been the result of changed perceptions of exchange rate risk by residents and non-residents alike which has led to a reduction in Japanese residents' desired level of foreign currency denominated assets and an increase in non-residents' desired holdings of yen assets, rather than any change in underlying trade and long term capital flows to and from Japan.

Nevertheless, the sharp change in relative prices consequent upon the yen's appreciation has been nonetheless real. Furthermore Japanese real domestic spending is now set to gain a further, equally as important, stimulus from the collapse in oil prices. Thus, even though the yen real effective exchange rate has not risen as far as in 1978 (see Chart 3) Japan should experience a cyclical upswing in the domestic component of economic growth at least as large as it did during the earlier episode of yen strength as the economy also enjoys a 'mirror image' of the 1980 oil shock. The nearly 60% fall in oil prices in yen terms since September on its own implies an increase in income for Japan equivalent to as much as US\$25 bn. It should also be noted that the implication of this is that

JAPAN: CHART 4
REAL INTEREST RATE



JAPAN: CHART 5
REAL MONETARY GROWTH



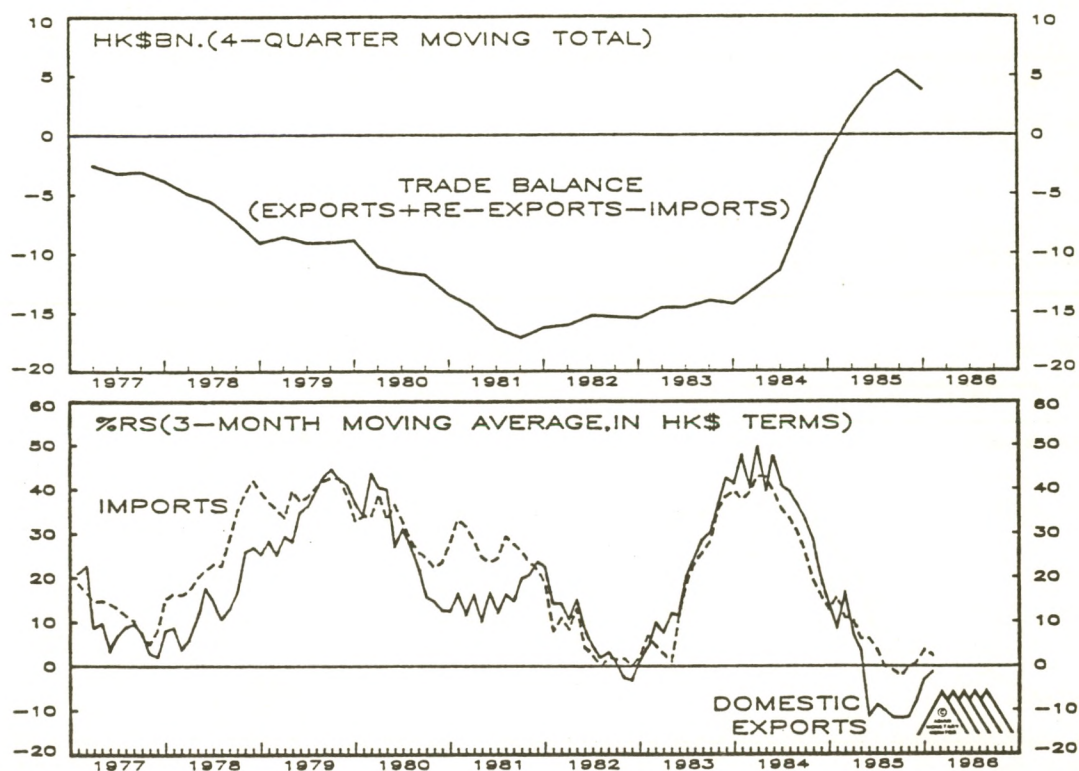
Japan's trade surplus in nominal terms will grow further in 1986/87, as happened in 1978.

The ultimate effect on overall economic growth of this 'one-off' increase in income depends upon how much of the increase is spent on domestic output versus how much is spent on imports, saved or taxed. To the extent that the increase is spent on domestic output the multiplier effects will lead to second, third, and further, round increases in income. However, for a domestic economic resurgence to be extended beyond a mere cyclical upswing into a secular trend depends clearly upon how increased savings are invested. The shift in relative prices resulting from the yen's appreciation suggests that the desired levels of the capital stock in the external and domestic sectors of the economy will have shifted such that investment in the domestic sector of the economy will now be a significantly more attractive proposition relative to investment in the external sector of the economy. However, if returns to investment in the domestic sector of the economy remain low in an absolute sense then it is possible that increased savings could just emerge in the form of capital outflows, ultimately weakening the yen once perceptions of exchange rate risk change again.

What is clear from this is that the current time represents an ideal one for a shift to much more accommodative monetary conditions in Japan. Chart 4 shows that, even after recent reductions in nominal interest rates, real interest rates in Japan remain relatively high, at least compared to those which obtained during the domestic recovery of 1978. If interest rates are lowered further then, given the shift in relative prices which has occurred, the marginal investment projects which become viable are now much more likely to be in the domestic sector, rather than the external sector, of the economy. Chart 5 also shows that, although real M2 growth is on an uptrend, there is still room for some further improvement, particularly as part of the recent increase in nominal M2 growth has been technical in nature.

FORECAST: Japan is set to experience a cyclical swing in the components of its economic growth rate similar to that which occurred in 1978, featuring a marked increase in the relative contribution of domestic spending - particularly consumption spending - to economic growth. It is likely that this change in the relative importance of domestic and external spending to Japan will be extended longer than was the case in 1978 because this time there have been two important relative price changes - oil and the exchange rate - as opposed to just one - the exchange rate - in 1978. Possibly offsetting this to a degree, however, is the fact that monetary conditions in Japan are less easy than was the case then. For the cyclical pattern of a stronger domestic economy to be further extended into a more secular change would require a change in the investment uses to which Japan's savings are put, and still lower interest rates would help in this respect in that they would encourage additional investment, which is now more likely to be in the domestic sector of the economy than before. In order for the momentum of an extended upswing in investment in the domestic sectors to be converted into a true secular change in the economy further domestic economic liberalisation may be required, to further raise the returns available to investment in the domestic sectors of the economy.

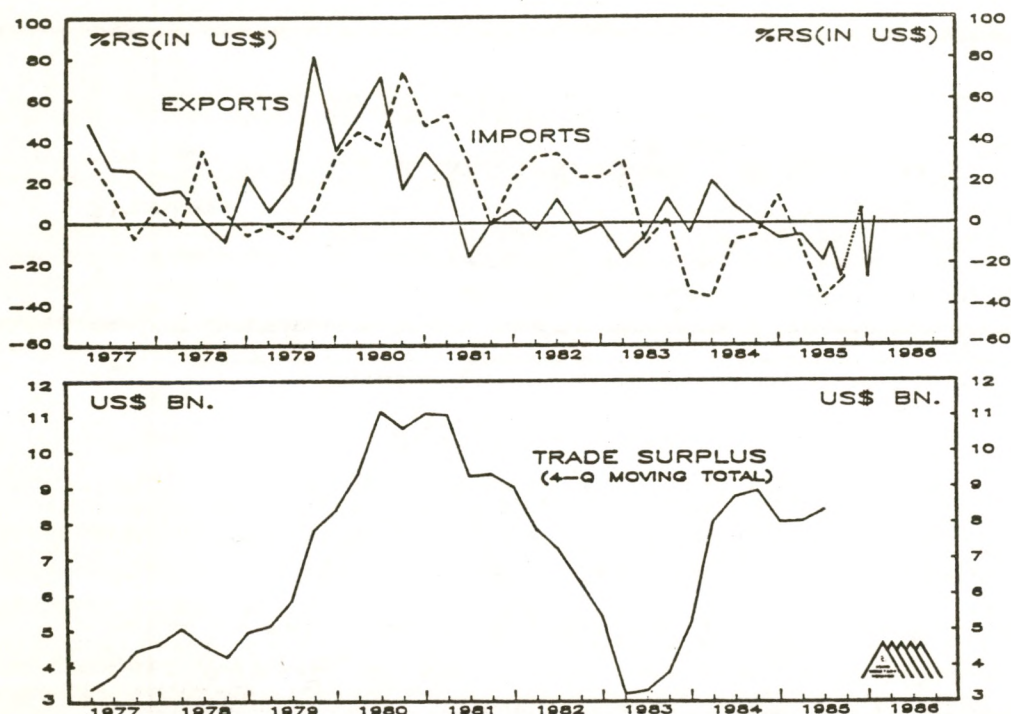
HONG KONG: EXPORT SURGE LATER THIS YEAR



Domestic export growth in January declined by 5.7% year-on-year, but comparing November-January with the same period a year ago, the figure then becomes -1.3%. The latter is an improvement upon -12% for the period August to October, which may indicate a bottoming out in the trend. Whether or not this actually occurs is dependent upon the behaviour of the US business cycle - particularly personal consumption expenditure - which has dominated trends in Hong Kong exports, resulting in the downturn in exports late 1984 and in domestic export growth turning negative as early as March 1985. Evidence of a strong upturn in US economic growth would thus bode well for Hong Kong exports. Indeed, the decline in the growth of exports to the US would appear to be slackening with November-January showing growth of -6% year-on-year, against -12% growth for the previous 3 months. Coupled with indications of improving demand from W. Germany, Japan and the UK - all have currencies which have appreciated against the HK\$ - the outlook is reasonably healthy. Against this, improved economic and demand conditions within these countries will take time to translate into export growth. Also, export demand from China, Hong Kong's second most significant export area in 1985, remains unfavourable: growth over November to January has slowed to a year-on-year rate of 3% compared to 107% in December to February 1984/85.

Although domestic export growth is reviving, it is likely to be somewhat restrained in the early part of the year until the effects of increased demand filter through. Due to a lower base of comparison, growth should improve after the initial months of the year, probably exceeding the government estimate of 7.5% (in real terms) for the year. After narrowing in the first half of 1986, the trade surplus should widen again in late 1986.

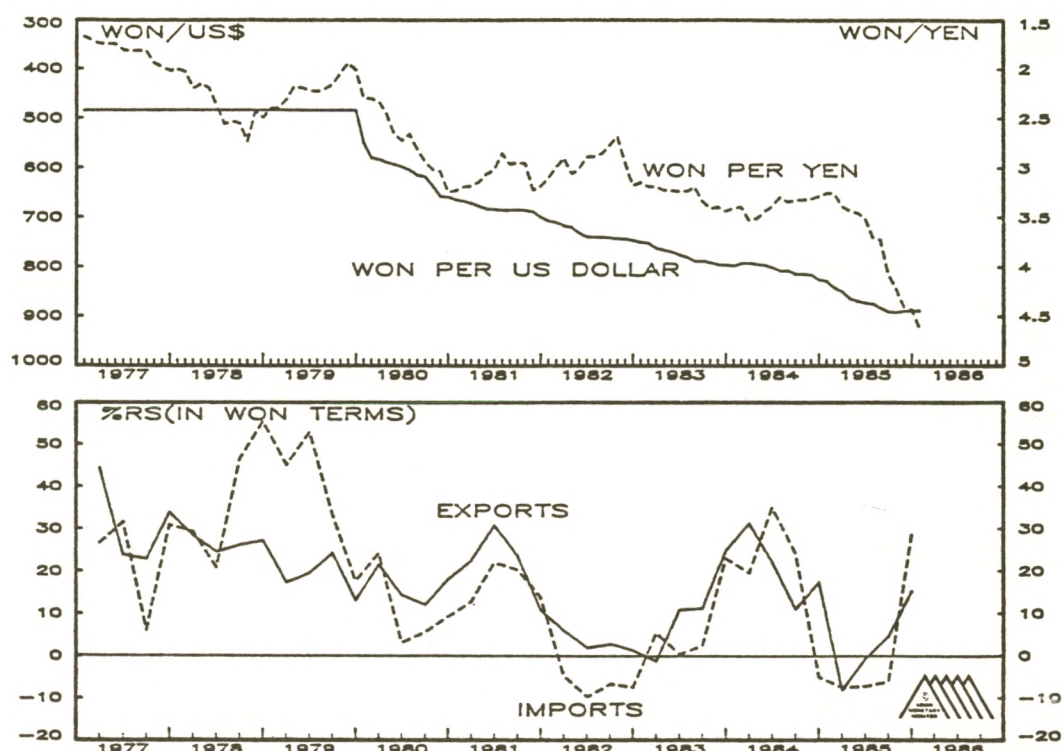
INDONESIA'S EXPORT EARNINGS AND GOVERNMENT REVENUES ABOUT TO COLLAPSE



The inability of OPEC to confront the 'free rider' problem typical of a cartel, has resulted in the present production expansion and its attendant price collapse. Although oil exporting countries should eventually benefit from a general economic upturn in non-oil producing countries, the outlook in the short run for Indonesia among others, is less than sanguine. Indonesia is heavily export dependent; in 1984 exports were 27% of GDP, of which oil represented nearly half. Between January and August 1985, petrol and products accounted for 41% of total exports, which becomes more significant when it is realised that the price of other non-oil exports were generally declining e.g. rubber, which was 7% of non-oil exports. Although Indonesia has attempted to reduce her dependence on oil exports (and the proportion of exports accounted for by oil does appear to be declining on a yearly basis), oil still dominates overall export growth. The poor performance of total export growth largely reflects the weakness of petrol products which slowed considerably over 1984, dropping to a year-on-year rate of -41% 1985 Q2. In contrast, non petrol exports held up until 1984 Q3, peaking at year-on-year growth of 38%, but they have since slipped, reinforcing the weakening trend in total export growth which recorded negative growth of -18% for 1985 Q2.

Despite deteriorating export performance, the trade balance improved marginally to \$2176 mn in 1985 Q2, reflecting weakness in imports. Also, revenues for oil and gas for FY 1985 were only 0.1% short of the budget figure and thus in the short term the impact of collapsing oil prices on government spending has been delayed. But with further oil production expansion unfeasible and non-oil exports inadequate, austerity is likely to intensify with downward multiplier effects from domestic and foreign consumption declines.

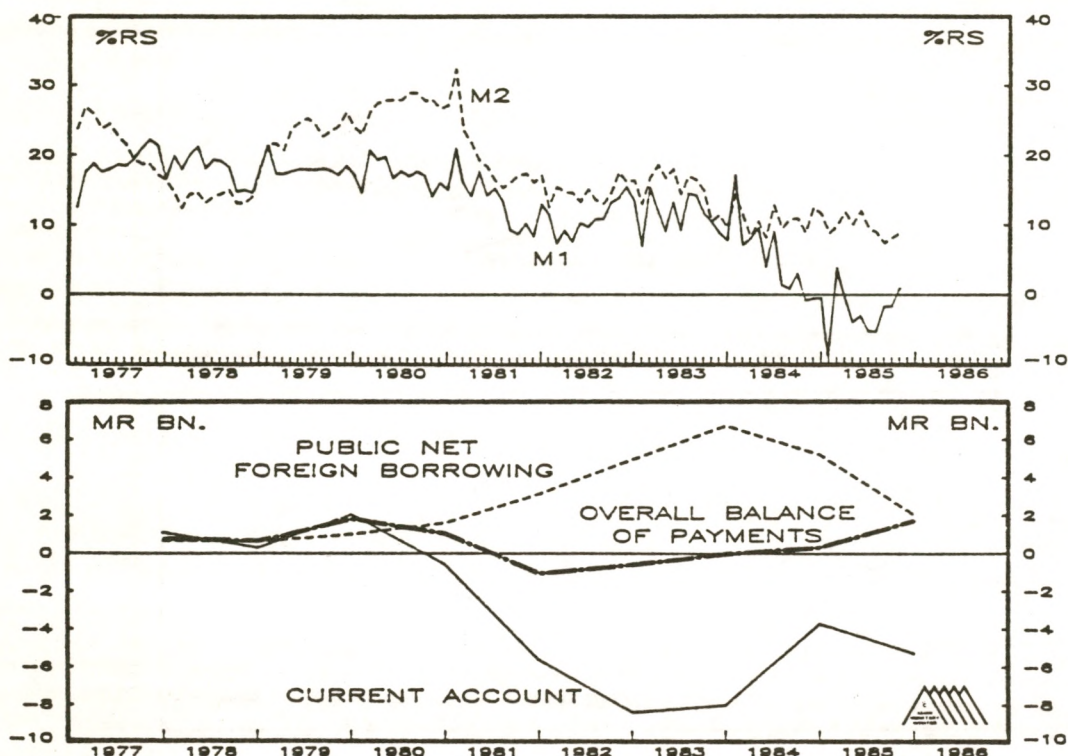
S. KOREA: CURRENCY DEPRECIATION AND LOW INFLATION SPELL UPTURN IN EXPORTS



Measures to improve Korea's current account would appear to be paying off. The trade deficit's fall to \$362 million in November resulted from increasing exports which could allow a reversal of the present liquidity squeeze. Exports have benefited from an improvement in competitiveness due to low inflation in Korea, and due to the depreciation of the won against the US\$ for the first 10 months of 1985. Although the dollar's depreciation against the major currencies after March 1985 has raised fears of imported inflation, monetary policy is not dangerously expansionary, and poses no threat to competitiveness in the long run.

The current upturn in exports to a year-on-year rate of 15% in 1985 Q4 reflects a cyclical upswing related to the US business cycle and is similar to previous upswings: in 1980-81 Korea experienced an export upswing comparable to the current revival. The January 1980 Won devaluation and its subsequent depreciation improved competitiveness against the US and Japan, and the short-lived 1981 recovery in the US sustained the export surge to a peak of 30.8% in 1981 Q2. In 1983-84 too, the export boom was entirely based on the US economic recovery: exports peaked at 32% in 1984 Q1, but fell to year-on-year growth of -8% in 1985 Q1 in response to the US mid-course correction. Unfortunately this downward movement was compounded by declining demand from other sources in early 1985, such as the P.R.C. Imports have generally responded to changes in the outlook for exports and the distinct upturn over the last quarter of 1985, with growth of 29%, appears to reflect this, with increased imports of capital goods. With exports expanding more rapidly than imports over 1985, the outlook for the trade balance is relatively sanguine, especially if Korea benefits competitively from depreciation, e.g. against Japan.

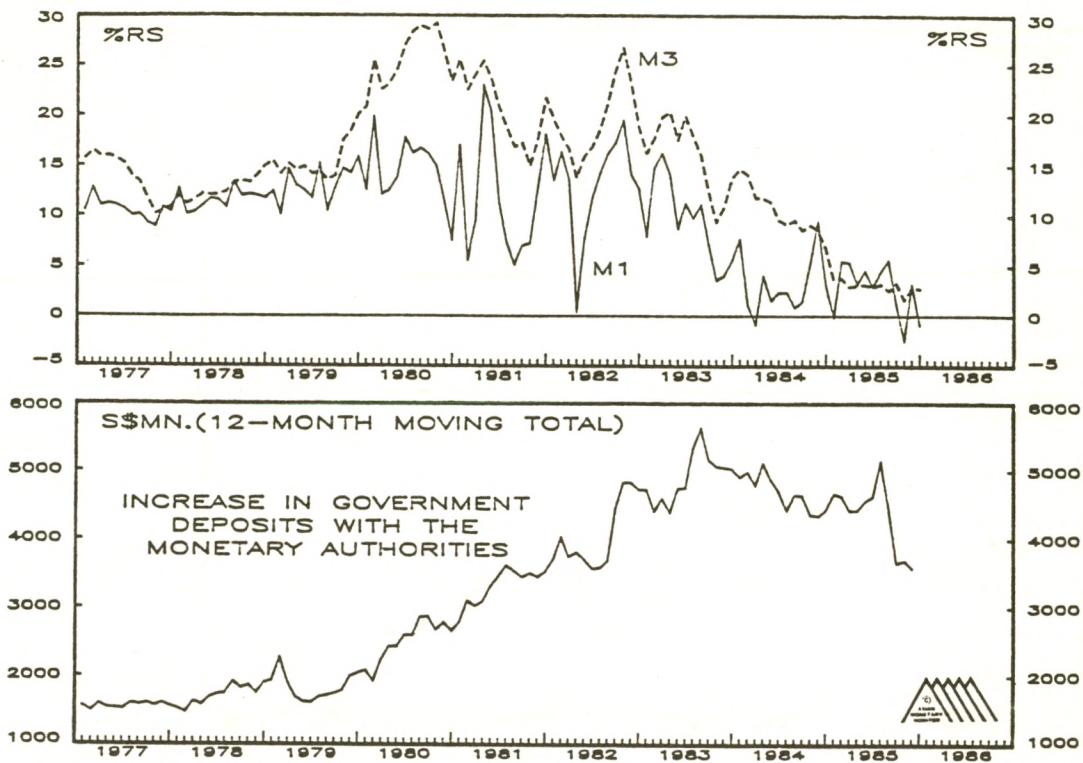
MALAYSIA: BALANCE OF PAYMENTS WEAKNESS CONSTRAINS LIQUIDITY



Although the rate of growth of the monetary aggregates slipped lower, liquidity conditions cannot be deemed to have been particularly tight in Malaysia last year. Bank Negara Malaysia (BNM) attributes the marked weakness of M1 growth to a structural fall in the demand for money M1. M2 growth, which bears a closer relationship to economic activity, did fall during 1985 but the 8.8% year-on-year growth rate reached by October still represents comparatively relaxed liquidity conditions when considered against the very slow rate of growth of nominal GNP - approximately 3% - last year. Reflecting this, interest rates in Malaysia were under downward pressure throughout most of 1985.

Notwithstanding weak commodity prices, monetary conditions in 1985 benefited from Malaysia's favourable overall balance of payments position - attributable to a large degree to repatriation of funds previously held offshore by Petronas - and overtly expansionary moves taken by the authorities. These included most notably a 1% reduction in commercial banks' reserve requirements, but also substantial liquidity injections effected by BNM through transfers of government deposits to the banks. However, in a managed exchange rate regime such as Malaysia's, in the long-run liquidity conditions are constrained by the performance of the balance of payments. In this respect, prospects for Malaysia this year do not appear bright. Even before the sharp fall in oil prices Malaysia's balance of payments appeared likely to deteriorate as a result of lower capital inflows. The recent two stage US\$10.80 per barrel reduction in Malaysian oil prices represents a loss to Malaysia's export revenues of close to M\$4 bn. Unless the government increases substantially its foreign borrowings liquidity conditions appear certain to tighten significantly over the course of the coming year as the balance of payments moves into large deficit.

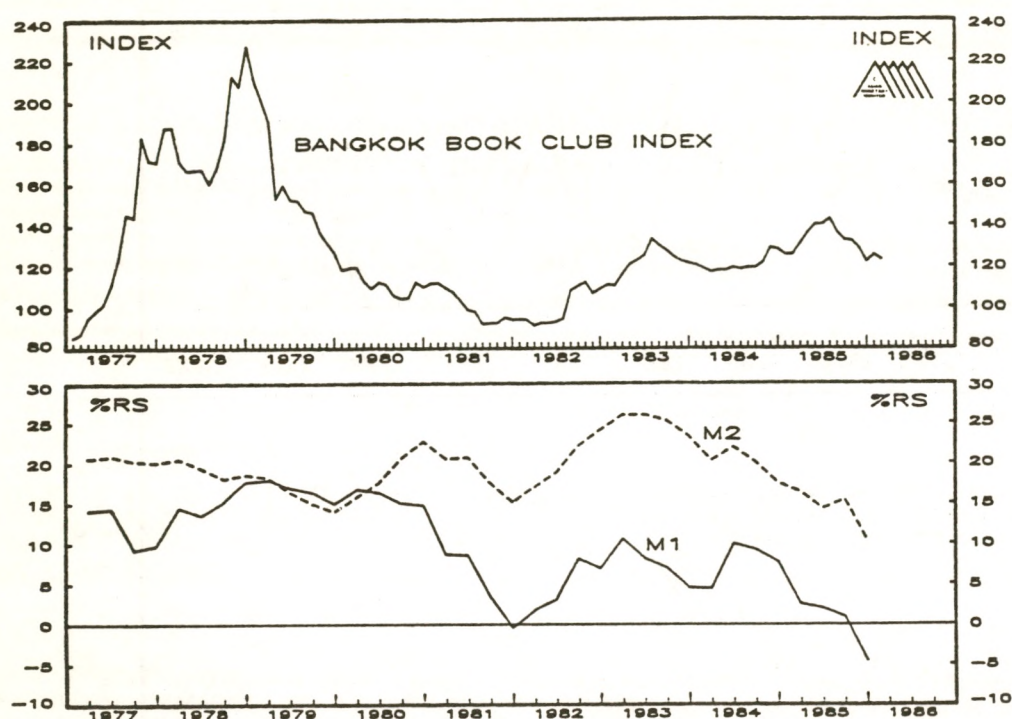
SINGAPORE: FISCAL STIMULUS TO RESTORE PRIVATE SECTOR LIQUIDITY



Money supply growth in Singapore has essentially been in a downtrend since 1980, when year-on-year M3 growth peaked at close to 30%. By October 1985 M3 growth had fallen to as low as 1.7% year-on-year. The extended downtrend in the rate of money supply growth has been primarily the result of the growing contractionary influence of the public sector, which ran a rapidly increasing surplus between 1980 and 1983. This surplus remained at high levels - at S\$4.5 bn, equivalent to roughly 17% of M2 - in 1984 and early 1985. The government appeared to follow this policy of running larger and larger surpluses - achieved through larger fiscal surpluses and successive rises in the rates of contribution to the forced savings scheme, the Central Provident Fund - in order to amass foreign exchange reserves.

In the light of the recession in the domestic economy the government has now radically changed this policy. The reshaping of policy began in April of last year with the establishment of an Economic Committee to study ways in which to aid the economy, and the committee has subsequently made proposals for a series of fiscally stimulative measures. These were formalised in the budget of March 7th for FY 1986. The measures the government has now taken - including a 7% corporate and personal income tax cut, a 25% personal tax rebate, a sharp reduction from 25% to 10% in the employers' contribution rate to the CPF and cuts in property taxes - should inject approximately S\$3.5 bn into the economy on an annualised basis. This will be enough to eliminate the government's monetary surplus (shown in the chart above) and, other things being equal, should lead to a substantial increase in the rate of monetary growth - to 20% or above - over the next year.

THAI STOCKMARKET AWAITS EASIER LIQUIDITY AND BETTER EXPORTS



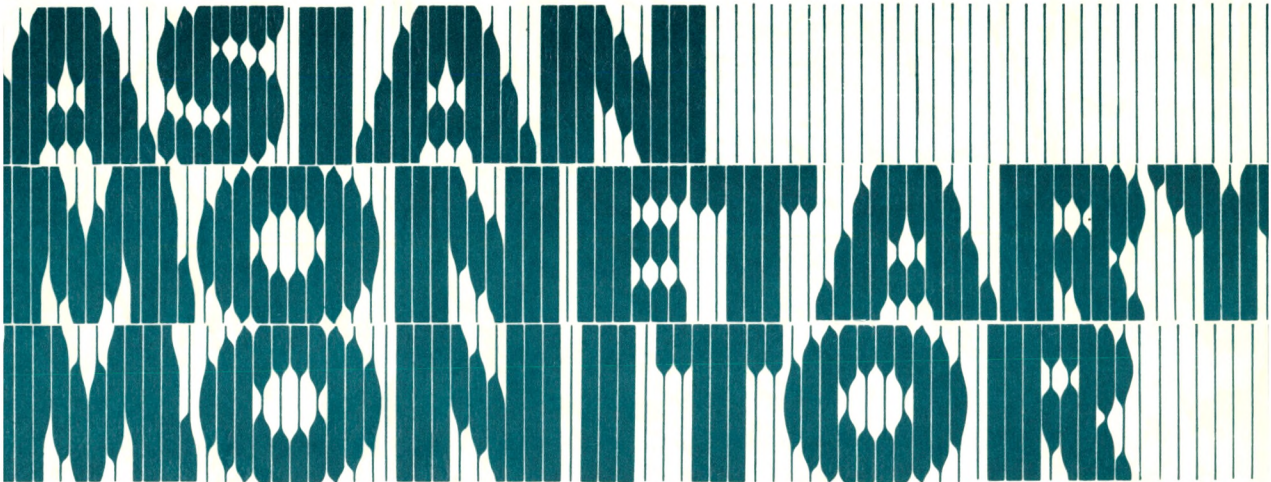
The Bangkok Book Club Index exhibited a disappointing trend over late 1985, declining 14% from July to February with asset values depressed by slow liquidity growth and poor external trade performance. M2 expanded at a rate of 10.6% over the year, while M1 grew at 2.6%, compared to 20% and 11.5% respectively for 1984. However, despite a slowing in the growth of M2 to a year-on-year rate of 10.9% in December, the trend appears to be bottoming out. The devaluation of the baht in November 1984 led to large capital inflows, but this was followed by a period of outflows due to uncertainty over the exchange rate and the related repayment of foreign debt. It is only recently that this situation has been reversed, boosting liquidity within the system. In response to this liquidity increase, interest rates were reduced in March, following on from December's changes. Loan rates were cut by 2% to 15%, while other rates including deposit and savings rates have declined. Given the world wide trend towards lower interest rates, this will not substantially narrow the differential with US rates and thus foreign borrowing is likely to continue, especially as the currency basket appears to have been adjusted to enhance the weighting of the US\$, partly eliminating the exchange rate risk for Thai borrowers of US\$.

Disappointing export growth over 1985 depressed GDP and corporate earnings, but in 1986 demand for manufactured goods should strengthen somewhat, as US growth picks up. The economy and the trade account will also benefit from declining oil prices, as Thailand imports about 60% of her oil needs. However, of more potential importance are declining agricultural export earnings which will weaken government revenues, restrict government spending, and could undermine both liquidity and the confidence necessary for a rising stockmarket.



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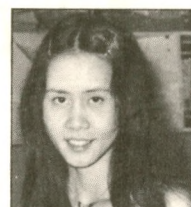
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KEYS TO SYMBOLS USED IN THE CHARTS

% RP	— Percentage Rate of change over Preceding period.
% RS	— Percentage Rate of change over Same period of preceding year.
SA	— Seasonally Adjusted.
SAAR	— Seasonally Adjusted at Annualised Rate.

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JAPAN

WILL THE YEN APPRECIATION CORRECT THE BALANCE OF PAYMENTS DISEQUILIBRIUM?

Japan's balance of payments disequilibrium, or more specifically its burgeoning trade and current account surplus, has for some time been a leading issue in international economic affairs - a key factor behind the world trend towards increased trade protectionism and also a factor behind growing disaffection with floating exchange rates. For Japan itself, the issue of the balance of payments disequilibrium has also been correctly perceived as important because it is integrally related with the imbalanced nature of growth of the Japanese economy, depending on one's point of view standing either as the fundamental cause of Japan's inability to produce balanced economic growth or as symptomatic of the persistent weakness of the Japanese domestic economy. The finance ministers and central bankers of the 'Group of Five' industrial nations effectively identified the yen/dollar exchange rate as being central to the balance of payments disequilibrium between Japan and the US. With the yen having now appreciated by over 40% against the dollar since the September 22nd agreement to cooperate in reducing the value of the dollar on the world foreign exchange markets, the G-5 initiative is widely seen as having been a success. However, now that a sharp appreciation of the yen has taken place and the Japanese currency is no longer clearly 'undervalued' against the dollar, consensus on any further course of policy action has evaporated, both amongst the G-5 and within Japan. For Japan the issue now at hand could be summarised in two questions: 1) Has the yen risen far enough to correct the balance of payments disequilibrium? (i.e. eventually eliminate the current account surplus) and 2) Will the structure of the Japanese economy be able to adapt to the new higher value of the yen to replace lost externally generated growth with domestic growth, or will the economy instead enter a serious recession? This article primarily addresses the first question - on the balance of payments disequilibrium - but suggests that the answer is inextricably bound up with the answer to the latter question.

Chart 1 illustrates the basic components of the overall balance of payments on a four quarter moving total basis, for the period 1977 to 1986. In the chart the scale for net long-term capital outflows (which are a negative in the balance of payments) has been inverted in order to highlight more clearly the development of the external payments imbalance over the 1981-1985 period. As is well known, the counterpart to Japan's huge and growing trade surplus has been a massive outflow of long-term capital representing a huge build-up in the country's net external assets. Also generally well understood is the fact that the expenditure counterparts to the capital outflow and trade surplus are an imbalance between savings and investment in the Japanese economy. Savings not invested in real assets represent an increase in net financial claims. For a

country considered as a whole, therefore, 'excess' savings represent an increase in net claims on the rest of the world. Conversely, the counterpart to Japan's growing net foreign assets is thus an excess of Japan's gross national savings over its gross capital formation, or investment.

Less well understood than these basic accounting identities is the process of cause and effect or the 'transmission mechanism' i.e. how, either, an excess of savings over investment translates into a current account surplus or, alternatively, a current account surplus leads to an imbalance between savings and investment. With regard to developments in Japan this is a critical issue because on it rests the question of appropriate policy actions to address the external payments imbalance.

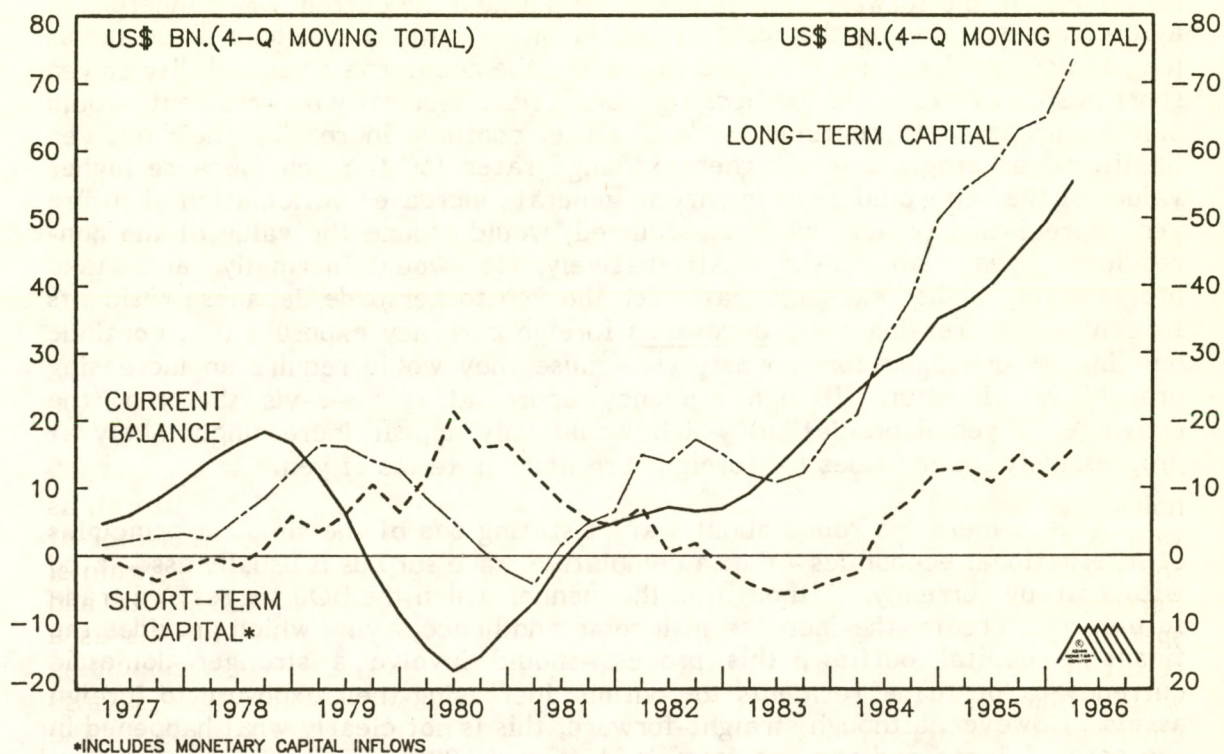
There are two basic views on how the external payments imbalance and the savings/investment imbalance in Japan have developed, which might broadly be described respectively as 'neo-classical' and 'Keynesian'. The 'neo-classical' view holds that savings in Japan have tended to be high because of socio-cultural, as well as fiscal, reasons, while the return to investment in the domestic sector of the economy has tended to be low, depressed partly by legislative constraints. Furthermore, the trend to deregulation of Japanese financial markets and specifically the liberalisation, in principle, of foreign exchange controls as a result of the New Foreign Exchange Control Act of December 1980, coinciding with a high and rising demand for savings in the US, led to Japanese savings emerging in the form of capital outflows to seek a higher return overseas. The rising level of capital outflows from Japan depressed the yen vis-a-vis the dollar, making Japanese exports more competitive and thus generating a trade surplus to finance the capital account deficit.

The alternative 'Keynesian' view, argued strongly by the Bank of Japan Research and Statistics Department in a Special Paper published in July 1985, sees the reverse causation. BOJ argue that Japan has experienced a trend growth in its trade surplus because the economy's export-related sector has enjoyed a 'virtuous cycle' of growth. Growing exports with a dynamic economic structure increasingly oriented towards the export sector has meant high growth of equipment investment in export-related businesses. This high rate of investment has resulted in an increased weight of export-related enterprises in Japan's industrial structure, increasing the export dependency of the economy, and has also raised productivity in the sector, reducing costs and making Japanese exports more competitive on world markets. This has encouraged further growth in exports, continuing the 'virtuous circle'. Furthermore, BOJ argue, because of the income inelasticity of demand for imports (consisting largely of primary goods), imports have not kept pace with rapidly growing exports, and the trade surplus has thus exhibited a growing trend. Growing net exports have then had a 'multiplier' effect on national income, increasing national income to the point where savings have increased to the degree of net exports. Increased savings, via capital outflows, have then financed the increase in the trade surplus.

However, while theoretically sound this latter argument appears empirically flawed, at least when applied to the period 1981 to mid-1985. As BOJ themselves point out, the build-up in Japan's net foreign assets (which reached US\$129.8 bn at end 1985) represents largely an uncovered, or unhedged,

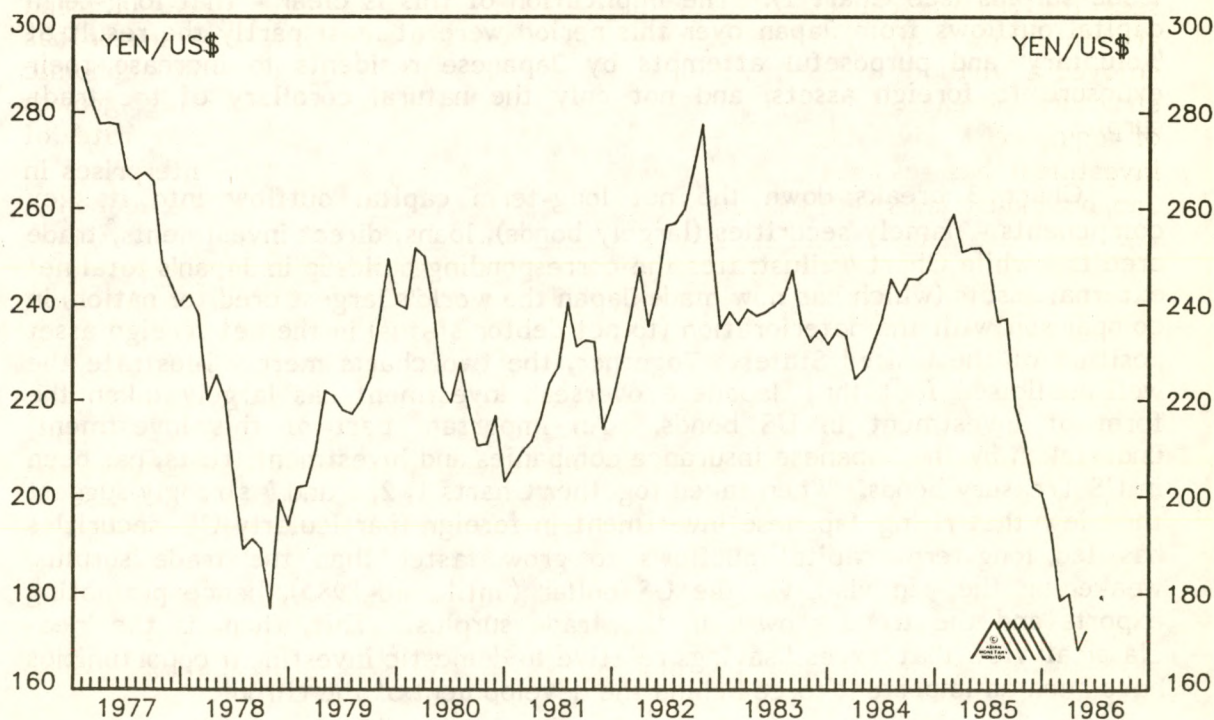
JAPAN: CHART 1

CURRENT AND CAPITAL ACCOUNTS OF THE BALANCE OF PAYMENTS



JAPAN: CHART 2

THE YEN/US DOLLAR EXCHANGE RATE

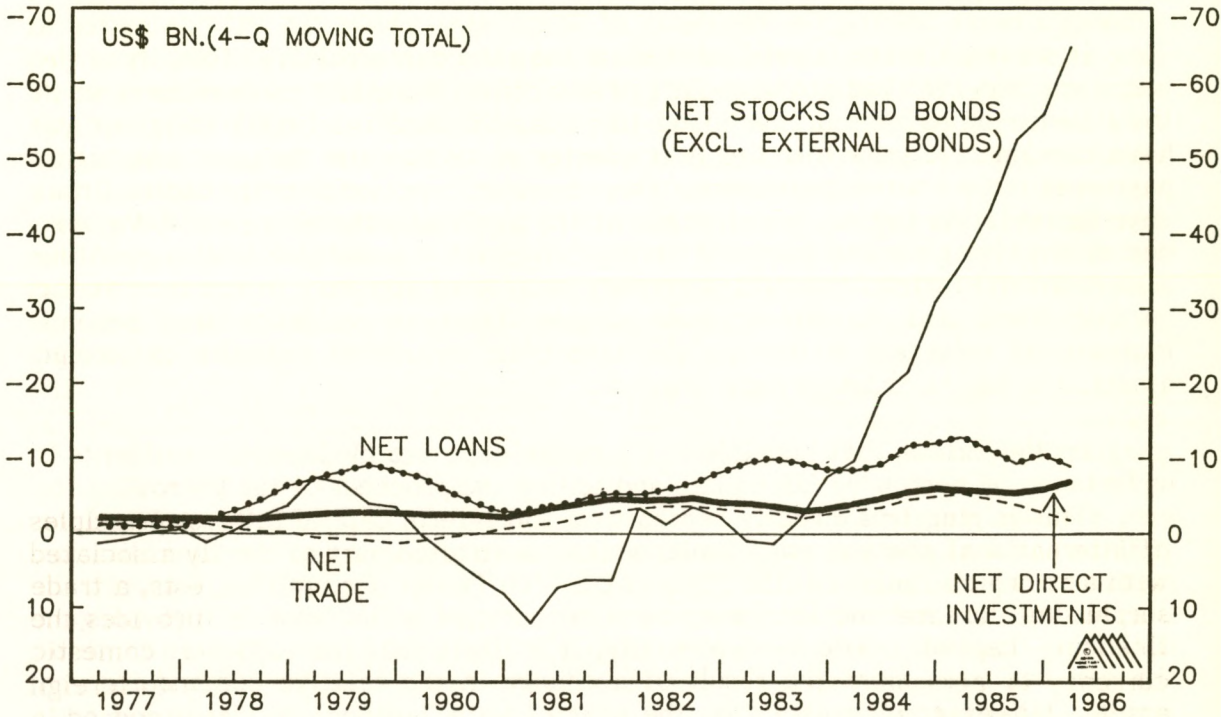


foreign currency exposure. This is because while individual transactors may hedge (e.g. in the forward foreign exchange market) the currency risk inherent in a foreign asset holding the residents of Japan as a whole can only do so for as long as non-residents are prepared to assume the counterpart yen liability or yen short position involved in the hedging transaction. Normally non-residents would only be prepared to continue to do this (i.e. continue increasing their net yen liabilities) at progressively higher exchange rates for the yen, because higher values of the yen would be necessary to generate increased anticipation of future yen depreciation (which, when it occurred, would reduce the value of the non-residents' yen liabilities). Alternatively, it would normally also take progressively higher exchange rates for the yen to persuade Japanese residents to continue increasing their uncovered foreign currency exposure (i.e. continue building up unhedged foreign assets) because they would require an increasing probability of future foreign currency appreciation vis-a-vis the yen (the converse of yen depreciation) which would only appear increasingly likely at progressively lower values for foreign currencies in terms of yen.

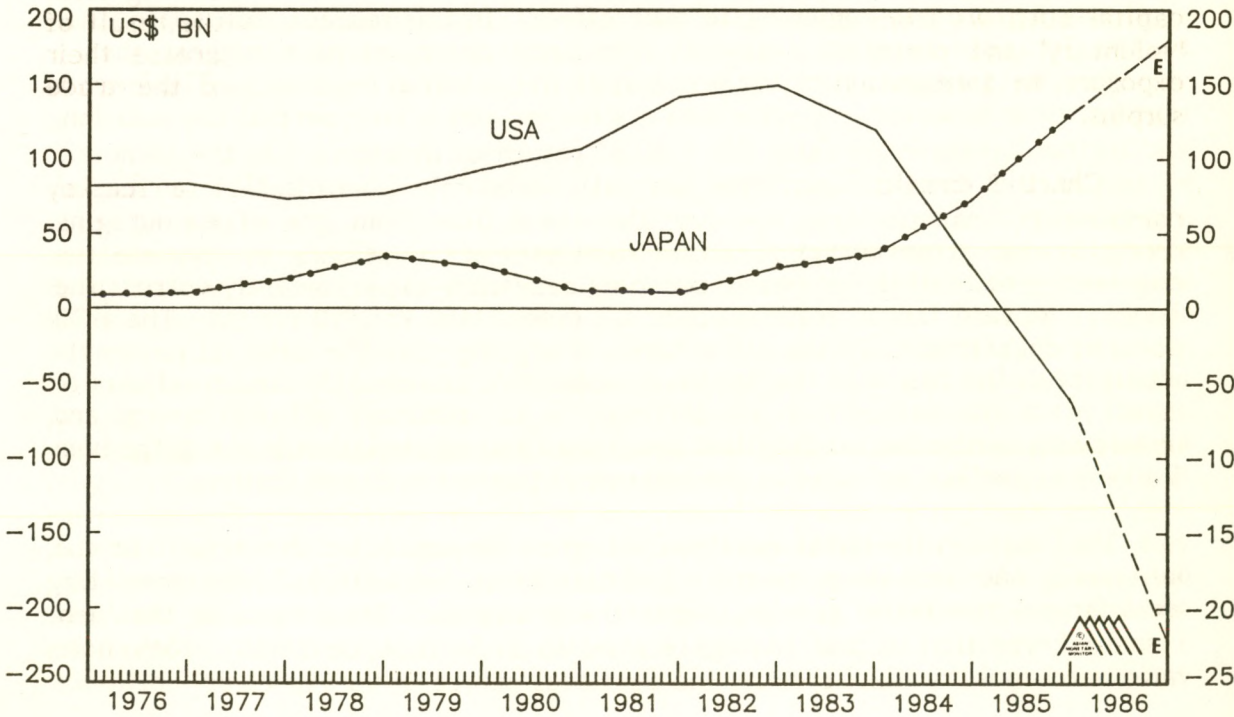
This is merely a round-about way of stating one of the simplest principles of international economics - that a cumulative trade surplus is usually associated with a strong currency. Although, in the manner which the BOJ suggests, a trade surplus will 'create' the increase in income and hence saving which provides the financing capital outflow, this process should involve a stronger domestic currency to 'persuade' residents to continue increasing their exposure to foreign assets. However, although straight-forward, this is not clearly what happened in the case of Japan and the yen from 1981 to mid-1985. The yen did strengthen against the European currencies in the latter part of this period, but against the US dollar, the destination for the bulk of Japanese capital outflows, it exhibited a generally weakening trend. Particularly noticeably, from March 1984 to March 1985 the yen weakened markedly, from US\$1=Yen222 to US\$1=Yen 262 (Chart 2) as net long-term capital outflows from Japan accelerated far in excess of the trade surplus (see Chart 1). The implication of this is clear - that long-term capital outflows from Japan over this period were at least partly the result of 'voluntary' and purposeful attempts by Japanese residents to increase their exposure to foreign assets, and not only the natural corollary of the trade surplus.

Chart 3 breaks down the net long-term capital outflow into its key components - namely securities (largely bonds), loans, direct investments, trade credits - while Chart 4 illustrates the corresponding build-up in Japan's total net external assets (which has now made Japan the world's largest creditor nation) in comparison with the deterioration (to net debtor status) in the net foreign asset position of the United States. Together, the two charts merely illustrate the well-publicised fact that Japanese overseas investment has largely taken the form of investment in US bonds. An important part of this investment, undertaken by the Japanese insurance companies and investment trusts, has been in US Treasury bonds. When taken together Charts 1, 2, 3 and 4 strongly suggest the view that rising Japanese investment in foreign (particularly US) securities has led long-term capital outflows to grow faster than the trade surplus, weakening the yen vis-a-vis the US dollar (until mid-1985), hence promoting exports and the trend growth in the trade surplus. This, then, is the 'neo-classical' view that 'excess' savings relative to domestic investment opportunities have been an important force behind the development of the chronic

JAPAN: CHART 3
 LONG-TERM CAPITAL ACCOUNT OF THE BALANCE OF PAYMENTS



JAPAN: CHART 4
 THE US AND JAPAN : DEBTOR AND CREDITOR NATIONS
 NET ASSETS OF US AND JAPANESE RESIDENTS HELD ABROAD



SOURCE : "SURVEY OF CURRENT BUSINESS" MINISTRY OF FINANCE, JAPAN

disequilibrium in Japan's balance of payments and is the approach which has been taken in past issues of AMM (see AMM Vol. 9 No. 2 and AMM Vol. 10 No. 2).

However, Charts 1 and 2 also show that the extraordinary strength of the yen since mid-1985 has not been part of any converse pattern of developments in the balance of payments. Net long-term capital outflows (in US dollar terms) have continued to grow into the first quarter of 1986, while the basic balance of payments (the current balance plus balance on long-term capital) has deteriorated. As the sudden strength of the yen could therefore not have been due to any change in the Japanese savings/investment imbalance (a change in the real economy) instead the BOJ argument must have applied - in the face of the chronic trade and current account surplus Japanese residents have become increasingly reluctant to further increase their uncovered exposure to foreign assets, and sought to hedge exposure.

To the extent that hedging of US dollar exposure by Japanese residents is undertaken by borrowing US dollars and selling the proceeds of the borrowing for yen, then hedging will directly represent a short-term capital inflow. The June 1984 removal of the yen swap limit, which constituted part of the liberalisation measures which followed the "Japan-US Yen/Dollar Committee Report", in liberalising such transactions, may have encouraged an increase in such hedging activity. However, more fundamentally, it is likely that the sudden strength of the yen has been more the result of a change in the relative demand for yen assets vis-a-vis foreign assets on the part of both Japanese residents and non-residents, revolving around the increasing realisation that the build-up in Japan's net foreign assets has become too rapid to be sustainable. In a sense, therefore, the chronic trade and current account surplus, even if not the original cause of Japan's savings/investment imbalance, has now become the leading factor in the determination of the yen/dollar exchange rate and in the balance of payments.

The strength of the yen, then, represents the free-market adjustment or equilibrating process beginning to take effect. In this respect both approaches to the Japanese external payments imbalance described here suggest that a stronger yen is a solution to the problem of the external imbalance. The 'excess savings' view, however, suggests that a stronger yen is only part of the solution, and further measures to raise the rate of return to investment in the domestic sector of the economy including domestic economic liberalisation, an easier monetary policy, measures to alter the fiscal bias from one of encouraging saving to one of encouraging consumption etc. are necessary to promote the long-term growth of the domestic economy necessary to permanently correct the tendency toward larger trade surpluses. (See AMM Vol. 10 No 2.) The BOJ research department, on the other hand, in arguing that the external payments imbalance is the result of the Japanese economy's increasingly structural bias to export promotion rather than any tendency to an imbalance between savings and investment, concluded (in July last year) that yen appreciation is the only, even if a very imperfect, solution to the balance of payments disequilibrium.

BOJ state in the paper that "promotion of yen appreciation seems to be the only basic macroeconomic measure for correcting the external imbalance" but see a large appreciation as being necessary to stimulate anything other than just a small correction of the payments imbalance on a value basis. They note various reasons for this: Firstly, the fact that increases in export dollar values

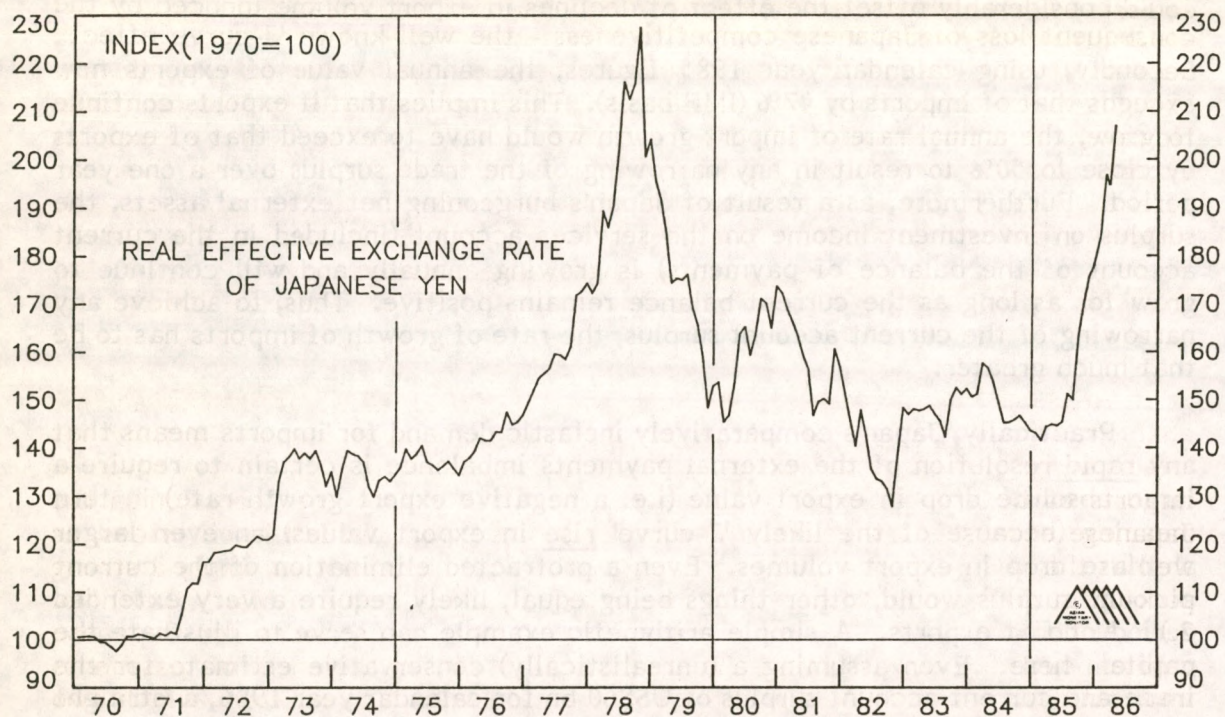
caused by Japanese exporters increasing dollar prices to protect profit margins could considerably offset the effect of declines in export volume induced by the consequent loss of Japanese competitiveness - the well-known 'J-curve effect'. Secondly, using calendar year 1985 figures, the annual value of exports now exceeds that of imports by 47% (IMF basis). This implies that if exports continue to grow, the annual rate of import growth would have to exceed that of exports by close to 50% to result in any narrowing of the trade surplus over a one year period. Furthermore, as a result of Japan's burgeoning net external assets, the surplus on investment income on the services account (included in the current account of the balance of payments) is growing annually and will continue to grow for as long as the current balance remains positive. Thus, to achieve any narrowing of the current account surplus, the rate of growth of imports has to be that much greater.

Practically, Japan's comparatively inelastic demand for imports means that any rapid resolution of the external payments imbalance is certain to require a large absolute drop in export value (i.e. a negative export growth rate) in turn meaning (because of the likely 'J-curve' rise in export values) an even larger absolute drop in export volumes. Even a protracted elimination of the current account surplus would, other things being equal, likely require a very extended period of flat exports. A simple arithmetic example can serve to illustrate the problem here. Even assuming a (unrealistically) conservative estimate for the trade and current account surplus of US\$60 bn for calendar year 1986, a 'straight line' reduction in the surplus - by US\$10 bn every year - to a zero trade balance by 1992 would still mean that Japan's net foreign assets would stand at roughly US\$350 bn by the end of that period. Even at a rate of return of only 6%, foreign asset holdings of this magnitude would generate an income stream of over US\$20 bn, leaving Japan's current account still in surplus. Thus, by implication, for the current account surplus to be totally eliminated, either the trade surplus must be reduced much more quickly (meaning, in effect, a sharp drop in export volumes) or export growth must remain very weak for a very extended period of time.

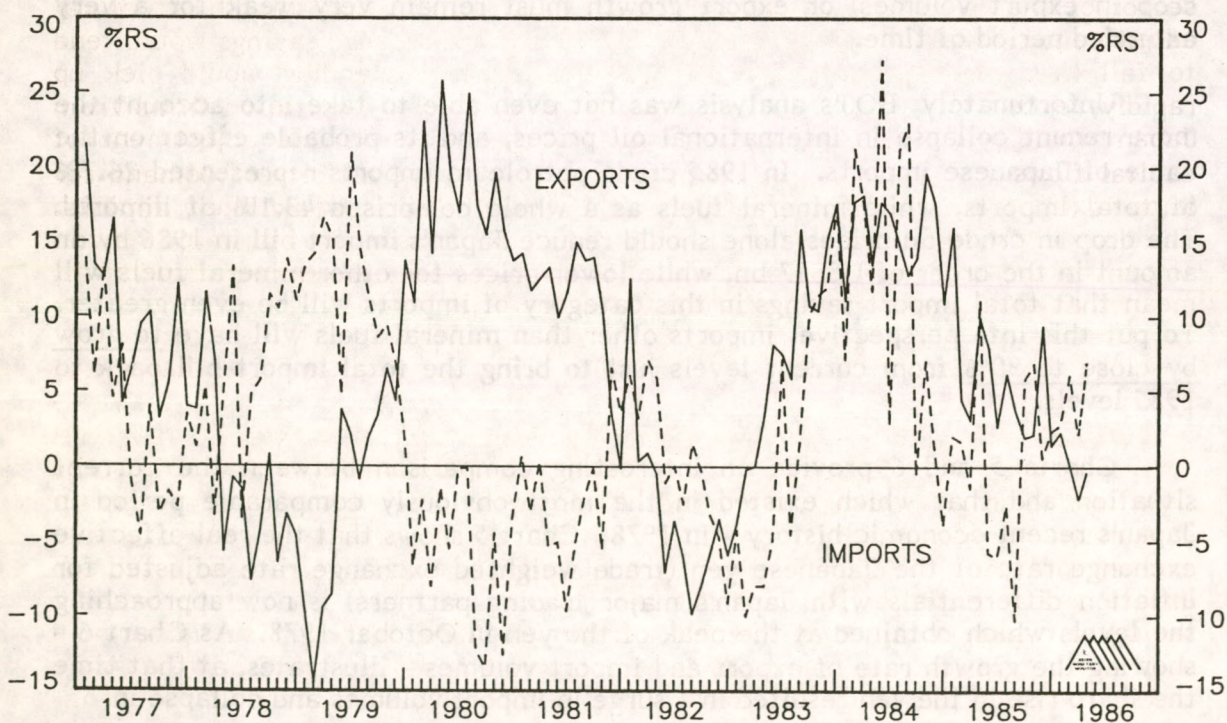
Unfortunately, BOJ's analysis was not even able to take into account the more recent collapse in international oil prices, and its probable effect on the value of Japanese imports. In 1985 crude petroleum imports represented 26.7% of total imports, while mineral fuels as a whole comprised 43.1% of imports. The drop in crude oil prices alone should reduce Japan's import bill in 1986 by an amount in the order of US\$17 bn, while lower prices for other mineral fuels will mean that total import savings in this category of imports will be even greater. To put this into perspective, imports other than mineral fuels will have to grow by close to 30% from current levels just to bring the total import bill back to 1985 levels.

Charts 5 and 6 provide an interesting comparison between the current situation and that which existed in the most obviously comparable period in Japan's recent economic history - in 1978. Chart 5 shows that the real effective exchange rate of the Japanese yen (trade weighted exchange rate adjusted for inflation differentials with Japan's major trading partners) is now approaching the levels which obtained at the peak of the yen in October 1978. As Chart 6 - showing the growth rate of export and import volumes - illustrates, at that time the sharp rise in the yen resulted in a surge in import volumes and collapse in

JAPAN: CHART 5
REAL EFFECTIVE EXCHANGE RATE OF JAPANESE YEN



JAPAN: CHART 6
QUANTUM INDEXES OF FOREIGN TRADE



export volumes which at the respective peak and trough, in early 1979, saw import volume growth at 20.9% year-on-year and export volume growth at -14.5% year-on-year. The effect of these volume changes on the nominal trade balance at that time is difficult to quantify because the adjustment process was brought to an abrupt halt and put sharply into reverse by the second oil crisis. However, it is interesting to note that when applied to the current levels of exports and imports, even assuming no unit value changes (i.e. no 'J-curve' effect), when taking into account the effects of the oil price collapse, these volume growth rates would not be enough to significantly reduce the current trade surplus over a one year period. This in itself would seem to suggest that the yen would have to rise further yet to correct the existing balance of payments disequilibrium.

However, all this is only very much in the nature of a partial equilibrium analysis. The simple arithmetic presented here all assumes 'ceteris paribus' but 'other things remaining equal' in the face of a collapse in exports and surge in imports of these magnitudes would necessarily imply a severe recession in the Japanese economy. In reality, the sharp rise in the yen and fall in oil prices, as well as the monetary and fiscal measures taken by the authorities, imply a strong pick-up in domestic economic activity. (This was discussed in AMM Vol. 10 No. 2.) A domestic economic recovery, in turn, has consequences for Japanese capital outflows which itself, in turn, has important balance of payments implications. This returns to the argument presented earlier, from which two basic scenarios can be derived:

1) The most favourable outcome for the Japanese economy would occur if the strong yen, in changing the relative rates of return to investment in the 'domestic' sector of the economy versus the 'external' sector, along with a favourable monetary and fiscal environment for consumption and investment, results in a rapid shift in economic resources from the external to the domestic sector of the economy, i.e. the economy enjoys a rapid and smooth structural adjustment to the new, high, value of the yen. Then, because savings would tend to fall (i.e. consumption would rise) and investment spending would pick up rapidly, 'excess' savings in the economy would diminish. Capital outflows from Japan would therefore fall and, because of the more flexible adjustment of capital flows and the comparative price and income inelasticity of demand for imports (as well as the 'J-curve') the capital account deficit would likely diminish more rapidly than the trade surplus. This would mean that the yen would remain strong, or perhaps even strengthen further, as the domestic economy picked up, further hastening the process of adjustment and more rapidly eliminating the current account surplus.

2) The least favourable outcome would occur if the domestic economy failed to recover i.e. the economy failed to undergo any structural adjustment in response to the strong yen. Compared to the first scenario, in this case imports would show less of an improvement (because of the absence of any significant recovery in domestic demand) and hence the yen initially could become very 'overvalued', as even more of the adjustment in the trade position would need to occur on the export side. However, in contrast to the previous case, the tendency to a savings/investment imbalance would remain because, although savings would drop - in response to falling incomes - investment spending would also fall, as a result of weak exports. Thus, there would be a continuing tendency to net long-

term capital outflows from Japan, which would mean that the possibility of yen weakness could quickly re-emerge. Therefore, the yen could be very volatile, but the scope for yen depreciation and any consequent recovery in exports would be increasingly limited over time in the face of Japan's large net external assets, which would represent an increasing foreign exchange risk to Japanese residents (tending to strengthen the yen). Effectively, therefore, Japan's economic growth would become constrained by the growth of the world economy and Japan would have to accept a significantly lower long-term rate of economic growth than that which it has enjoyed in the past.

These two 'extreme case' scenarios clearly point to the desirability of a strong yen exchange rate not only to correct the external payments imbalance but also to encourage growth in the domestic sector of the economy. The suggestion here is that the more rapidly growth becomes concentrated in the domestic sector the longer the yen will remain stable and 'firm', as capital outflows will tend to diminish.

FORECAST: The magnitudes involved in Japan's balance of payments disequilibrium have become enormous, and unprecedented in economic history. Simple arithmetic can shed some light on the extent, or duration, of export slowdown which would be needed to eliminate the current account surplus. Whether the yen has now risen far enough to prompt such a slowdown in exports is difficult to ascertain, particularly as the impact of currency changes on export volumes at the margin is likely to become progressively greater for higher values of the yen. However, a casual comparison with the similar circumstances existing in 1978, when the real effective exchange rate for the yen reached even higher levels than those obtaining currently, suggests that the yen might have to rise still further. However, the position is complicated by possible structural change in the economy, as resources shift from the external sector of the economy to the domestic sector in response to the higher yen. In the best possible case, a rapid and flexible structural adjustment from export-led to domestically-led growth could enable the yen to remain firm (but not excessively 'overvalued') for an extended period of time and induce a relatively rapid elimination of the current account surplus.

PEOPLE'S REPUBLIC OF CHINA CONTRADICTIONS BETWEEN SOCIALIST PRINCIPLES AND 'CAPITALIST' DEVELOPMENT

The Seventh Five-Year Plan, approved on 12th April 1986, continues clearly with the process of reform of the Chinese economy begun when Deng Xiaoping took effective power over the People's Republic in late 1978. Most importantly, the plan further extends the process by which economic reform has become increasingly identified with the use of free-market forces, as opposed to state planning, to achieve economic objectives. However, as free markets develop to the extent that the momentum to reform is increasingly growing in response to the market itself as much as in response to political motivations and is increasingly centred in the industrial, as opposed to agricultural, sector the contradictions inherent in the authorities' policy of using 'capitalist' tools while attempting to adhere to 'socialist' principles are becoming increasingly apparent. Apart from political and social problems - such as widespread corruption - specific macro-economic problems China has faced, including overheating of the economy, inflation, loss of foreign exchange reserves and loss of monetary control have also been well-publicised. To a large extent these problems have been by-products of the broader difficulty of transposing the reforms which have been so successful in rejuvenating the agricultural sector to the state industrial sector. However, as the period encompassed by the Seventh Five-Year Plan (1986 to 1990) progresses it is likely that the more basic problems associated with the conflict between 'capitalism' and 'socialism' in the Chinese economy will become increasingly evident. Needless to say, how successive conflicts between the interests of economic development and interests of adherence to basic socialist principles are resolved politically will indicate to what extent the Chinese are prepared to sacrifice socialism in the interests of economic development, and hence will determine the future of the Chinese economy.

The Background to the Seventh Five-Year Plan

It could be tempting for observers to equate socialism with the principle of egalitarianism and China's obvious abandonment of equality in favour of incentives as tantamount to 'going capitalist'. However, such a view would be somewhat simplistic. In agriculture, for instance, in the earlier years of collective farming in China (the period of the 1950s until 1958), a philosophy comparable to the current slogan 'to each according to his work' and systems of responsibility less advanced but nevertheless similar to the current 'Responsibility System' were prevalent. The 'iron rice bowl' and 'everybody eating from the same big pot' policies of guaranteed jobs and extreme equalitarianism were peculiar to the Maoist movements of the 'Great Leap Forward' (1958-60) and 'Cultural Revolution' (May 1966-October 1976). (In this respect it should be borne in mind that a considerable part of the rapid growth in agricultural output since 1976 could be attributed to the 'bounceback' in output from the economic stagnation which characterised these periods of extremist policies as well as to the independent growth momentum generated by the movement to economic reform in China.)

The three principles which the authorities in fact see as basic to socialism in China are 1) public ownership of the means of production, 2) the elimination of 'exploitation' through the principle of "from each according to his ability and to each according to his work" on the basis of the public ownership of the means of production and 3) a planned economy based on the public ownership of the means of production. Of these three principles probably only the first two are considered sacrosanct as they are fundamental to the Marxist belief in the avoidance of 'exploitation' of labour through the distribution to labour of the full value of output in accordance with the labour theory of value. The third principle - of state planning - has in the past been a necessary adjunct to the first principle in that state ownership, which effectively is the only feasible mode of public ownership in industry, tends to imply state planning.

There are two basic forms of public ownership in China - the collective, or cooperative, which involves the joint ownership of the means of production (land and capital) by the members of each workers' cooperative, and is the dominant form of ownership in agriculture, and state enterprise, which involves ownership by the government and is dominant in industry and commerce. The emergence of these two forms of ownership in the different sectors of the economy was essentially a historical development connected with the transformation of China into a socialist economy. However, at least for the key sectors of agriculture and industry the two forms probably represent the only practical respective forms of public ownership. Given the constraints imposed, numerous practical problems have made the principle of the workers' collective less easily applicable to industry. Foremost amongst there are the obviously more complex problems of management and administration in industry, the question of responsibility for operating losses of a cooperative within the socialist context, and, perhaps most importantly given the historical dominance of heavy industry in the industrial sector of the Chinese economy, the extreme difficulty of raising capital other than from effectively state sources (see below). These factors, and others, have made state ownership the logical form of public ownership in the industrial sector, and once the principle of state monopoly ownership is established state planning of output and prices becomes a natural consequence.

By the same token, the relatively less complex nature of rural production and the comparative independence of the collectives (meaning that they were potentially responsive to incentives) made agriculture a clear likely beneficiary of reform. Thus, although the 'Four Modernisations' programme of December 1978 gave equal emphasis to urban and rural areas, the rural areas sped towards progress more rapidly. Initially the rural reform effort begun by the 'Four Modernisations' concentrated primarily on correcting the perceived imbalance in the economy between consumption and investment (in favour of increased consumption spending) and raising farm incomes (and to this end the prices paid by the state for agricultural produce were raised significantly in 1979) but by 1984 the focus of reform was squarely on rural growth and development through the encouragement of private plots, free markets and individual entrepreneurship as exemplified by the rapid development of rural light industry.

Rural reform has been associated with three major developments. Firstly, the rights of ownership and decision making power over the land, property, machinery etc. and their use by the collectives have been established and clearly defined. Secondly, and importantly, the 'Four Modernisations' established the

'Responsibility System' in agriculture. Under this system was implemented the Household Contract System. Instead of working for the collective a farm household enters into contract with the collective for the right to use a tract of land to grow a certain quantity of a certain crop. The household responsibility is to pay agricultural taxes (10% of yield value) and to sell a required quota of produce to the State. Earnings from sales to the State are divided into two portions; one goes to the collective or the production team and the other to the farm household. After selling the required quota to the State, the household can keep the rest of the produce for its own use or sell it in the free market for a profit. In the beginning these 'leases' were only for three years, but the short duration led to maltreatment of draught animals, machinery and equipment and it proved expedient to extend 'leases'. It is now possible to obtain fifteen year contracts (fifty for Horticulture) and from 1983 contracts have been transferable. Thirdly, the reforms have encouraged the use of land for private purposes including growing crops to sell on the free market as well as household-based 'sidelines', the basis for the rapidly growing rural light industry. Complementing this aspect of the reform movement the development of free markets has been encouraged. Price controls on more than 10,000 products were lifted as early as 1979 and the number of commodities for which prices are allowed to be freely negotiated increased rapidly from 1980. State subsidies on staple food items in the urban areas were terminated in May 1985, finally bringing the prices of staple foods in the cities more into line with the free market prices.

The reforms in agriculture had immediate and clear results. Agricultural production grew at an annualised rate of 10.1% between 1979 and 1985 (according to IMF data), and grew particularly rapidly in 1984 and 1985 when it recorded growth rates of 17.0% and 13.0%, respectively (see Chart 1). Furthermore, following the reforms China now produces more than twice as much grain as Russia from a smaller acreage and has changed from being a net importer to a net exporter of grain and other agricultural products such as cotton and vegetable oil. By way of comparison, during the period from 1949 to 1978 the implementation of a rigid soviet-style economy produced an annual increase in grain production in the order of only 2%.

Reform of industry, starting from a point where enterprises, being state owned rather than collectively owned and hence treated as departments of government agencies and managed as such, has proved a much more complex matter. Prior to 1978 enterprises were required to hand over all their profits to the state budget, which in turn covered their losses and provided their investment funds in the form of a grant from the budget. The initial years of reform (1979-1981) focused on changing this basic pattern in an attempt to make industrial enterprises more efficient. Procedures were changed to encourage bank loans rather than state finance for the purchase and upgrading of equipment, enterprises were permitted to retain some of their profits and to use retained profits to pay workers incentive bonuses, or increase their benefits in kind. However, the major difficulty encountered was that with government agencies as the exclusive buyers and sellers of industrial products at prices rigidly controlled by the government, the profitability of any individual enterprise was as much dependent on the prices set for its outputs versus the prices set for its inputs as on efficiency or any other economic concept. In 1983 15% of China's factories lost money primarily because of the state administered

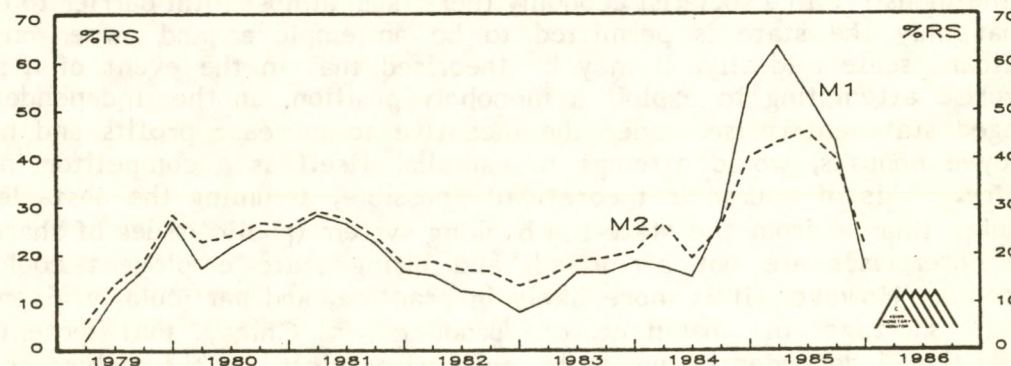
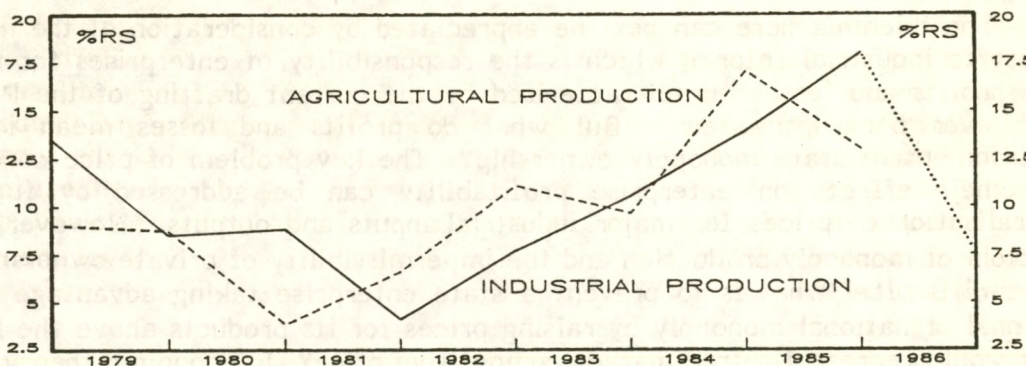
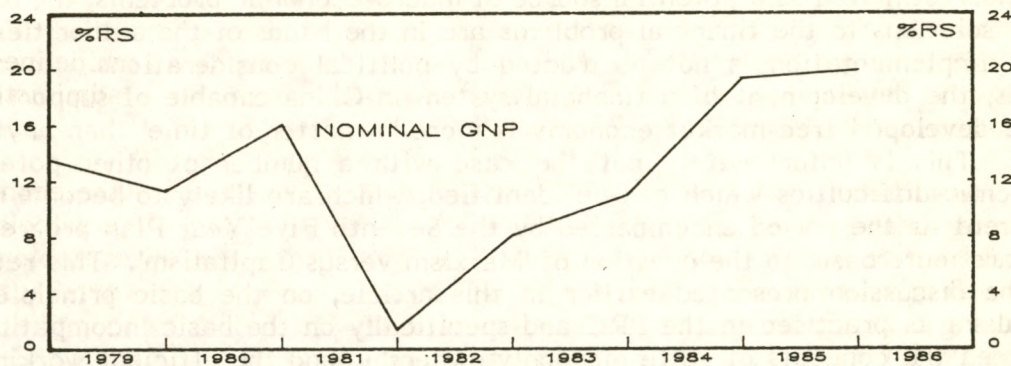
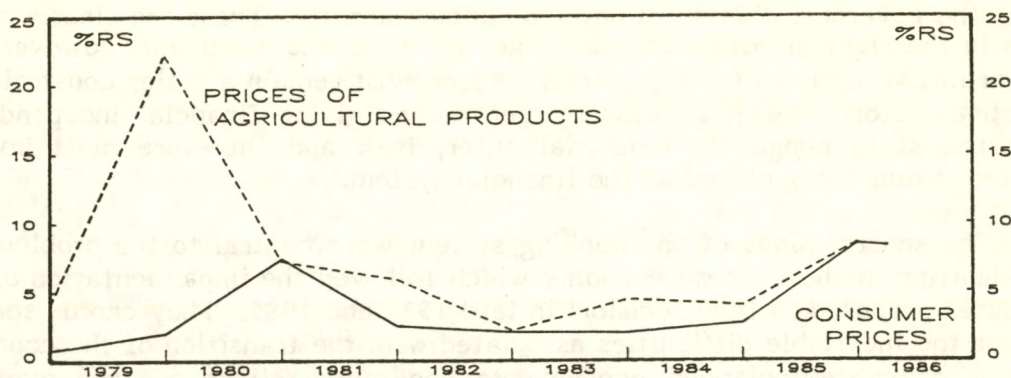
pricing system. The October 1984 'Decision on the Reform of the Economic Structure', in stating that the "reform of the price system is the key to reform of the entire economic structure", effectively recognised this problem.

The October 1984 'Decision', introduced at the third Plenary Session of the Twelfth Central Party Committee called for "the reform of every aspect of the entire economic structure" and essentially laid the groundwork for industrial reform in China. The ultimate aim of the 'Decision' is to reduce state planning to only basic heavy industry with factory managers in the rest of the industrial sector being free to run their enterprises without interference from the state. Under the reform industrial companies are responsible for their own profits and losses, retaining their profits and instead paying taxes to the government, employees work contracts rather than being given guaranteed jobs for life (with enterprise managers having the right to hire and fire workers), wage discrepancies for jobs of different skills are encouraged, and workers' bonuses were endorsed. The 'Decision' also instigated widespread price reform with more than half the products under state control put under general guidelines or released to market forces beginning in 1985. The remaining state administered prices were to be adjusted more frequently.

The October 1984 'Decision' had immediate consequences for the economy and unfortunately they were not all desirable. Enterprise managers took the endorsement of bonuses as a signal to pay out large bonuses to their employees, often effectively financing them with bank credit. The huge wage increases and ballooning bank credit resulted in an explosion in the money supply. In the first half of 1985, total industrial output value jumped 23.1% from year earlier levels as the economy grew out of control, given impetus by runaway growth in capital construction, which surged by 43.5%. Largely in response, the government introduced a new national wage system in July 1985. This 'Structural Wage System' splits wages into four parts - the Basic wage, which is uniform for all state employees, job wage, which is specific to the duties required, service length allowance, which is based on the number of years employed and the bonus, based on yearly assessment. However, the major consequence of the runaway economy was a government enforced slowdown which began to take effect in the second quarter of 1985 (see Chart 1). This clampdown, which involved strict controls on bank credit, use of foreign exchange, and capital investment by enterprises necessarily involved a significant degree of 'backtracking', at least on the spirit of the October 1984 reforms.

To a large extent these recent problems in the Chinese economy resulted from the still very primitive nature of China's financial system and the consequent inability of the People's Bank of China (PBOC) (given the absence of monetary instruments at its disposal) to control the money supply in any means other than through direct credit controls. These issues were examined in detail in an article in AMM Vol. 9 No. 4 but it is worth noting here that recent announcements by the head of the Central Bank and the government make it clear that the authorities have recognised this and are in the process of taking measures - including fundamentally changing the interest rate system (to allow higher interest rates), further liberalising the banking system and allowing competition between the four 'specialist banks', and permitting the use of cheques by individuals - which could go a long way to eventually rectifying some of China's basic monetary problems. In this regard in April, the Vice-President

CHINA: CHART 1 MONEY, OUTPUT AND PRICES



of the PBOC stated that the aim was to develop a nationwide financial market which the government does not have to control directly. These are clearly major steps in the right direction for the longer term. In the meantime, however, the still primitive nature of the financial system must remain a major constraint to industrial reform which necessarily centres on giving financial independence from the state budget to industrial enterprises, and therefore must involve greater strains being placed on the financial system.

The shortcomings of the banking system were central to the problems of over-heating in the Chinese economy which followed the implementation of the measures proposed in the 'Decision' in late 1984 and 1985. They can be seen as part of the inevitable difficulties associated with the transition of the economy from a completely planned economy to one more reliant on free markets. Moreover, although the lack of development of China's financial system cannot be underestimated as a potential source of macro-economic problems, the longer term solutions to the financial problems are in the hands of the authorities and their implementation is not obstructed by political considerations. In other words, the development of a financial system in China capable of supporting a more developed free-market economy is more 'a matter of time' than anything else. This is unfortunately not the case with a number of other potential economic difficulties which can be identified, which are likely to become more apparent as the period encompassed by the Seventh Five Year Plan progresses, and are more basic to the question of 'Marxism versus Capitalism'. This returns to the discussion presented earlier in this article, on the basic principles of socialism as practised in the PRC and specifically on the basic incompatibility between the concepts of state monopoly ownership and the efficient working of free markets.

The dilemma here can best be appreciated by consideration of the major thrust to industrial reform, which is the responsibility of enterprises for their own profits and losses, as characterised by the current drafting of the PRC's first ever bankruptcy law. But what do profits and losses mean in an environment of state monopoly ownership? The key problem of price controls and their effects on enterprise profitability can be addressed by further liberalisation of prices for major industrial inputs and outputs. However, the problem of monopoly production and the impermissibility of private ownership is more difficult. What is to prevent a state enterprise taking advantage of a regional or national monopoly by raising prices for its products above the level that would represent a free market competitive price? In economic theory, the ability of a company to charge monopoly prices rests on the 'barriers to entry' into the industry. In a socialist economy there is an almost total barrier to entry in that only the state is permitted to be an employer and owner on any significant scale. Ideally, it may be theorised that in the event of a state enterprise attempting to exploit a monopoly position, another independently-managed state enterprise, under the incentive to increase profits and hence employee bonuses, would attempt to establish itself as a competitor in the industry. This of course is theoretically possible, assuming the obstacles of obtaining finance from the state-run banking system (public issues of shares in state enterprises are not permitted) and hiring state employees could be overcome. However, it is more likely in practice, and particularly given the general shortage of manufactured products in China, that potentially competitive independently-run state enterprises, left to themselves, would

eventually act as cartels. A host of other shortcomings in this form of industrial system can also be foreseen, amongst them the fact that innovation and entrepreneurship are stifled because the supply of entrepreneurs is effectively limited to the existing managers of industrial enterprises and the fact that there is limited clear incentive for enterprises to make the most effective use of their assets because there is no 'takeover constraint' i.e. it is not possible for anyone other than the state to acquire ownership of the enterprise.

Up until now, the questions posed by these issues have not been at the forefront of discussion either inside or outside China because they clearly represent problem areas which will only begin to become apparent when the industrial reform, currently in its early stages, has become more entrenched and industry has become more developed. For the time being, the obvious benefits to output of increasing profit incentives and encouraging the growth of free markets will tend to outweigh other considerations. Nevertheless, it is interesting to note that the workings of market forces have already led to a rapid growth of stock issues, where permitted, which in itself has raised the controversial political issue of share ownership which is central to the question of public versus private ownership. This has been a very interesting development which bears examination here.

The impetus to the explosive growth of stock issues (which are essentially bonds) in China has arisen as the direct result of bank interest rates being maintained by the authorities at far too low a level (i.e. at a level far below the marginal return to capital investment) and hence is a classic case of disintermediation from the banking system. Because, given the low rate of interest, the only way PBOC has been able to control the money supply is through credit controls, bank credit has been strictly rationed since early 1985. In this environment, enterprises capable of earning a high return on capital have resorted to issues of stock which individual investors, eager to obtain higher returns than those available on bank deposits, have been very keen to acquire. The first such public stock issue was that of the municipal authority of Foshan City, in July 1984. Like succeeding issues, stocks issued represented a cross between shares and bonds in that they provide a guaranteed income to the investor, but also pay additional dividends depending on the profit of the enterprise. Also like succeeding issues, the Foshan City shares are transferable but not publicly tradable.

The first public sale of shares by an industrial enterprise took place in February 1985, and following that share issues by non-state owned (i.e. collective and rural industries, municipal authorities) enterprises grew rapidly during the year. The authorities, however, were cautious in their approval with several key officials including Chen Muhua, President of PBOC and Deng Xiaoping himself, feeling constrained to point out that stocks and shares are not freely tradable and emphasise that "socialist public ownership will ultimately predominate in China". Nevertheless in March of this year state owned enterprises were permitted to issue stock for the first time, although on a limited basis and only to their own employees. Even though a State Council report in early 1985 came out in favour of issues of stock by state enterprises to their own employees, seeing share issues as a way in which state enterprises could be transformed into collectively owned enterprises, left-leaning members of the government and Marxist scholars within China remain bitterly opposed to the concept. In that

the ownership of shares potentially enables an individual to share in the profits of an enterprise without contributing any labour, on a strict Marxist interpretation share ownership represents a form of 'exploitation'. Thus, share issues challenge the basic tenet of socialism, meaning that the extent of the political constraints to further economic reform within the PRC can be effectively gauged by consideration of further developments in this area.

The Seventh Five-Year Plan

The Seventh Five-Year Plan, for the period 1986-1990, is very significant in that it is the first five year plan to focus on economic reform and hence, as the first 'free market' plan represents more a statement of policy than the traditional plan of output and investment targets. The plan aims "To create a favourable economic and social environment and maintain a basic balance between social demand and supply so as to facilitate the reform and to lay most of the groundwork for a new type of socialist economic structure with Chinese characteristics within the five years or a little longer. To maintain a steady growth of the economy and, while controlling the scale of investment in fixed assets, vigorously push forward the construction of key projects, the technological transformation of enterprises and the development of intellectual resources, so as to prepare the materials, technology and trained personnel required for continued economic and social development in the 1990's. To further improve the living standards of the people in town and country, on the basis of increased production and better economic performance." The favoured terms in the plan - 'decentralisation', 'responsibility' and 'independence' - give the key to its general thrust.

Thus the Seventh plan is a very welcome reassurance that, in spite of the problems which have plagued the Chinese economy over the past eighteen months, the government continues to believe that the correct policy course is towards greater reliance on free markets, rather than direct control by the state, to achieve economic development aims. However, the plan is vague on implementation and, in the light of the discussion above, various potential problems likely to be encountered in the practical implementation of the broad concepts incorporated in the plan, can be foreseen. These can best be considered with reference to the specific guidelines discussed in the plan.

The eleven guidelines to development outlined in the plan are as follows:

1) Decentralization of financial control - Greater local autonomy to increase financial efficiency, promote competition and increase local awareness of fiscal constraints. The main problems in this area lie in the problems of fiscal and monetary control, discussed in AMM Vol. 9 No. 4. Although it is clear that the authorities are moving in the right direction to the development of an efficiently functioning independent financial system in China, progress will necessarily be slow. In the meantime, any major effort towards decentralisation is likely to meet with similar problems to those encountered in 1984/85 i.e. complete loss of fiscal and monetary control. Secondary problems are those associated with corruption and local favouritism, which tend to detract from economic efficiency.

2) Reform and Development - Catch up with the industrialised nations as far as

production techniques and management skills are concerned. One of the many drawbacks of this notion is the temptation, evident in China over the past six or seven years, to resort to highly capital intensive production (using imported equipment) to copy Japanese production techniques when labour intensive production would be more appropriate. In fact, given the abundant supply of labour but shortage of capital in China, true and complete reliance on free markets and comparative advantage would almost certainly imply that it would be an extremely long time before China attained the level of production automation of industrialised nations because production would largely be concentrated in low technology labour intensive areas.

3) Balance Social Demand and Supply. Of course in a pure 'free-market' economy this function is performed by the price system and the extent to which it is still not performed efficiently in China is largely the result of certain prices still being fixed by the state for goods not sold freely. However, the Seventh Five-Year Plan suggests further progress will be made in this direction.

4) Economic Results, Quality and Quantity - addressing the major problem of the increasing output of sub-standard goods. This problem can be seen as a direct result of the major barrier to competition imposed by the non-permittance of private enterprise. In a freely competitive economy competition, or the threat of it, prevents companies from consistently providing sub-standard products. However, in China's system as it now stands, it is difficult for profit-seeking state enterprises to avoid the temptation to meet heavy demand for goods by boosting output at the expense of quality, as consumers often have little alternative. It is not clear how this problem can be avoided while competition remains restricted and ultimately, in the absence of radical economic reform, it is likely to lead to state interference in the form of government-enforced quality control.

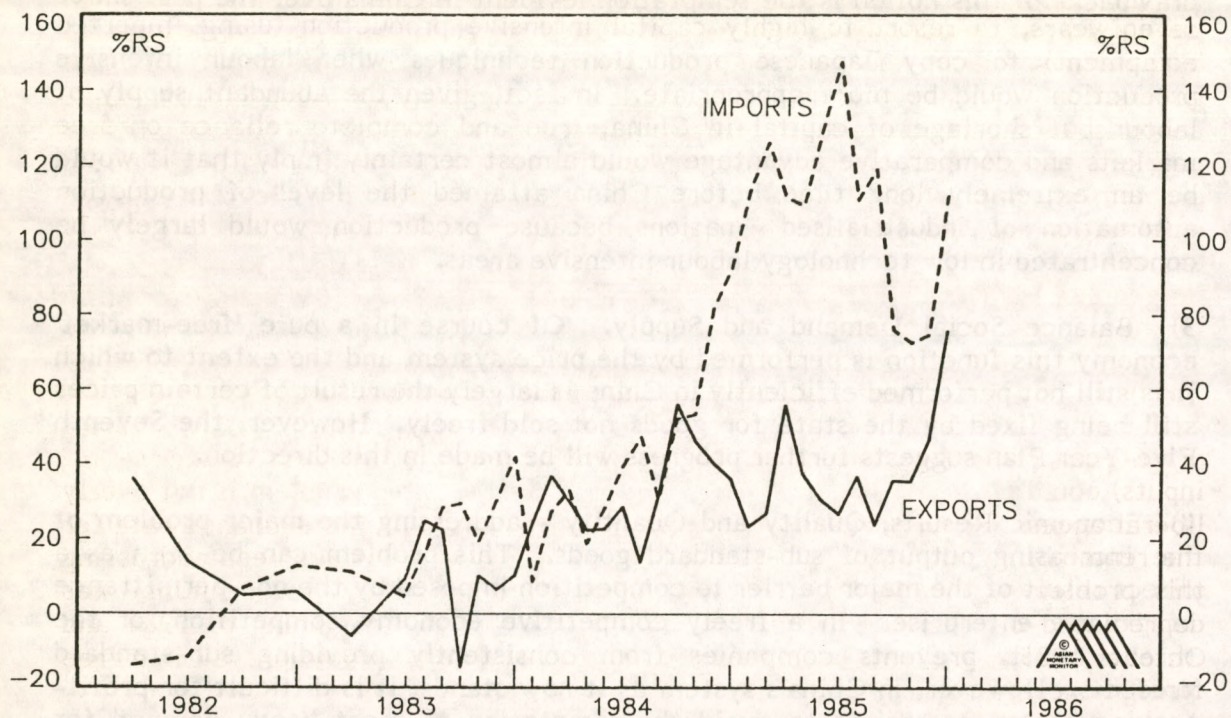
5) Rationalise the Industrial Structure. The rapid development of rural light industry has already gone a long way to redressing the balance between heavy and light industry in the Chinese economy. However, again, the problem remains that in the absence of private enterprise fully efficient rationalisation of the industrial structure is unlikely to take place.

6) Rationalise investment in energy, transportation, telecommunications. The lack of development of the economy's infrastructure is a major constraint to China's growth. However, the key problem here is the fiscal one and, as in all developing economies, it is difficult for the government to achieve the right balance between the need for infrastructural development and the desire to avoid depriving the 'corporate' sector of capital.

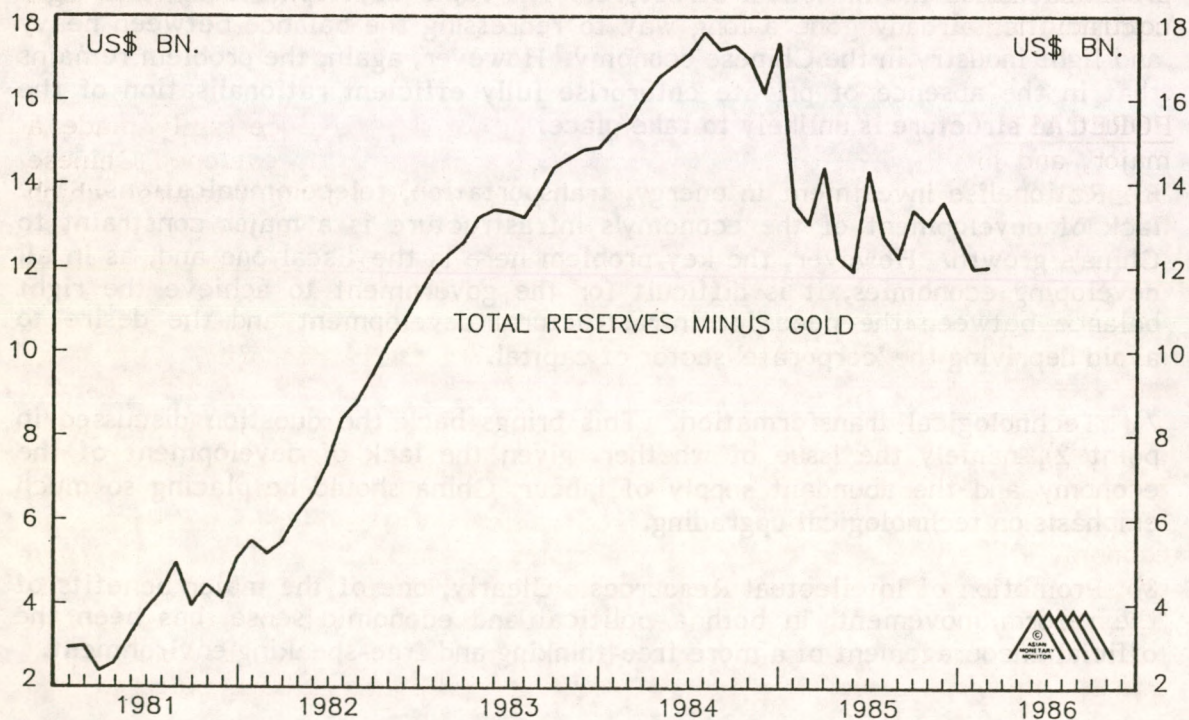
7) Technological transformation. This brings back the question discussed in point 2), namely the issue of whether, given the lack of development of the economy and the abundant supply of labour, China should be placing so much emphasis on technological upgrading.

8) Promotion of Intellectual Resources. Clearly, one of the major benefits of the reform movement, in both a political and economic sense, has been the official encouragement of a more free-thinking and free-speaking environment.

CHINA: CHART 2 EXPORTS AND IMPORTS GROWTH



CHINA: CHART 3 FOREIGN RESERVES



9) Open to the Outside World - the 'Open door' policy. The 'open door' is a commendable policy, but one which has run into many problems, the most publicised of which have been the many difficulties (due to excessive bureaucracy, lack of coordination between different elements of the government, the absence of a clearly defined company law, foreign exchange controls etc.) encountered by foreign investors in China. A whole further problem area is that of economic policy with regard to trade. An often noted problem is that, while imports into China tend to run at high levels, Chinese enterprises are unwilling to export because they are barely able to satisfy demand in the domestic market. In April 1985, the government's response to the burgeoning trade deficit and sharp drop in foreign reserves which followed the liberalisations made possible by the October 1984 'Decision' was to clamp down strictly on the rules governing the use of foreign exchange (i.e. the system of foreign exchange quota allotments) and on 'black market' activity in foreign exchange. Such measures are taken at the expense of efficiency because sectors or enterprises which could benefit in economic terms from access to imports (of inputs) could be deprived of them. It is clear that the main problem is not overly liberal access to foreign exchange but the maintenance of the exchange rate for the renminbi at 'too high' a level. Although the authorities have been addressing this problem by sharply depreciating the Chinese currency (the renminbi was depreciated by 38% against the US dollar between the beginning of 1984 and October 1985) the renminbi still remains above levels that would prevail in a free foreign exchange market.

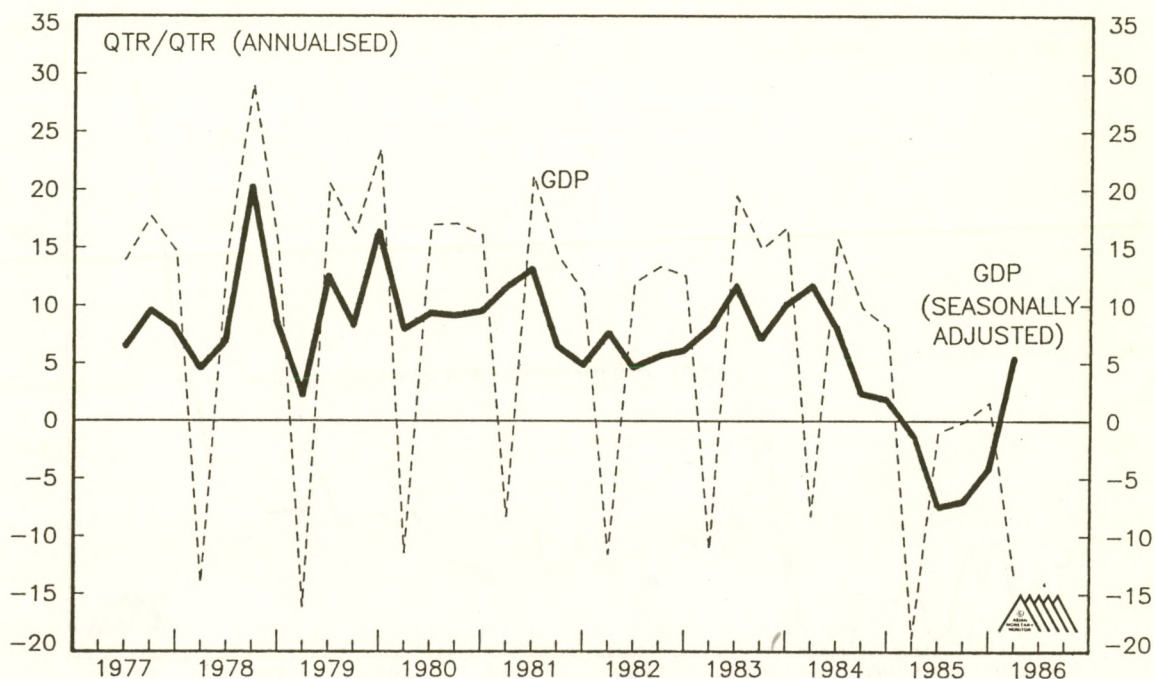
10) Further improve the material and cultural lives of both urban and rural residents. This firmly places the emphasis on economic growth.

11) Promote the cultural and ideological advance of socialist society while furthering its material progress. This final guideline almost represents a summary of the previous ten and, perhaps ironically, encapsulates many of the problems faced by the Chinese economy in the potential conflict and contradictions represented by its twin aim.

FORECAST: To summarise, the Chinese authorities have certainly made a major, and historic, move in the direction of progress to a developed Chinese economy in the implementation of sweeping economic reform measures which have taken place since 1978 and been accelerated since 1984. However, the path to economic progress has already been somewhat troubled. A very important constraint to the achievement of balanced non-inflationary economic growth has been the lack of a developed banking system capable of financing industrial growth in an independent, but macro-economically controlled, way. This is an unavoidable problem of the transition from a planned to a market-based economy which the authorities are doing their best to rectify but in what is an inevitably slow process. A much more fundamental problem, which is likely to become increasingly evident as the economy continues to develop, is the basic inconsistency between the two aims of achieving a developed market-based economy while retaining the major principles of Marxist socialism. The main problem here is the issue of public ownership versus private enterprise. The Seventh Five-Year Plan is again praiseworthy in that it takes as its central theme the need for continued economic reform, but in that it does nothing to address this key issue, suggests that further problems - both political and

economic - lie in store for China. We should thus expect the very much 'stop-go' pattern to economic development in China to continue over the period encompassed by the plan.

SINGAPORE HAS PASSED THE TROUGH OF THE RECESSION

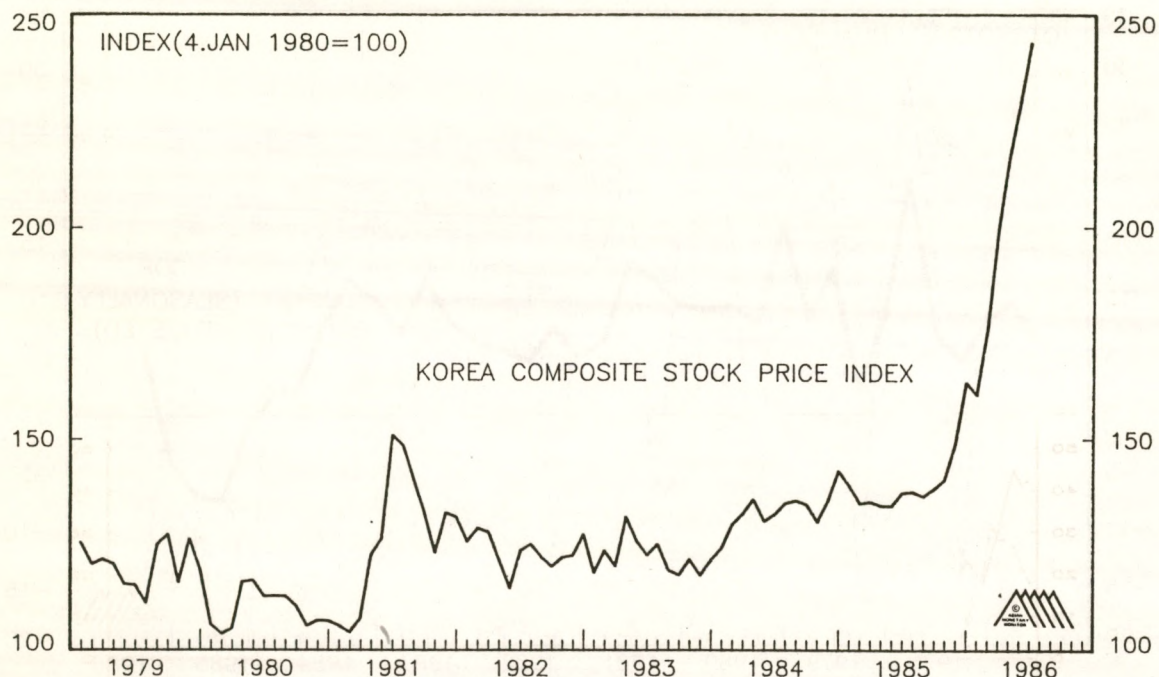


For 1986 Q1, real GDP registered growth of only -3.4% year-on-year, which represents the fourth consecutive quarter of negative growth. Considered in isolation the figure is disappointing, but it does mask important indications that economic growth may already have bottomed.

Quarterly growth in Singapore has a particularly strong seasonal bias which is readily apparent when the series is presented to highlight recent developments, as in the chart above. If we adjust the series to compensate for this seasonality by means of a log moving average method, it takes on a smoother trend which is more representative of the underlying growth path of the economy. This adjusted series suggests that growth bottomed during the second quarter of 1985 and that it is now improving, in the first quarter rising to 5.6% quarter-on-quarter annualised, compared to the official figure of -3.4% year-on-year.

Although these figures lend support to a more optimistic assessment of the Singapore economy, the recovery is still at best patchy. Construction activities declined further during the first quarter owing to overcapacity, although transport and communications (22% of GDP in 1985) showed strength in growth of 7.7% year-on-year, in contrast to 3.6% for the preceding quarter. Domestic exports performed poorly at the beginning of the year, but they staged a turnaround in April, expanding at a 3% year-on-year rate compared to -10% in March, reflecting increased demand from Japan and the US - Singapore's major trading partners. The depreciation of the Singapore dollar against the Pound, US\$ and yen will help to sustain this trend and offset the effect of sluggish regional demand. But despite this, growth will be fairly weak over 1986, although it should exceed the government estimate of -1.5%.

S.KOREA: STOCK PRICE SURGE REFLECTS EASIER LIQUIDITY, IMPROVING ECONOMY

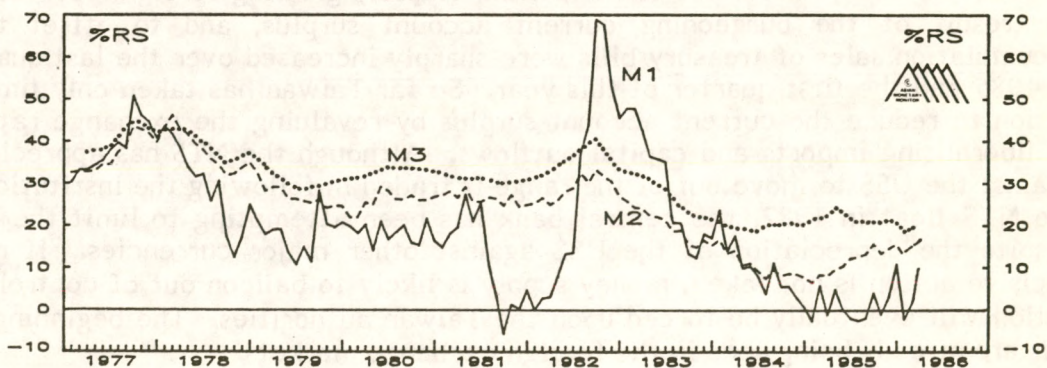
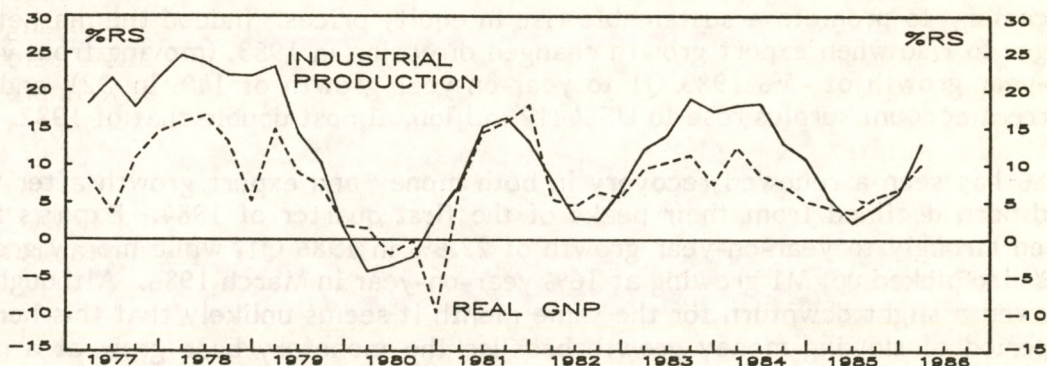
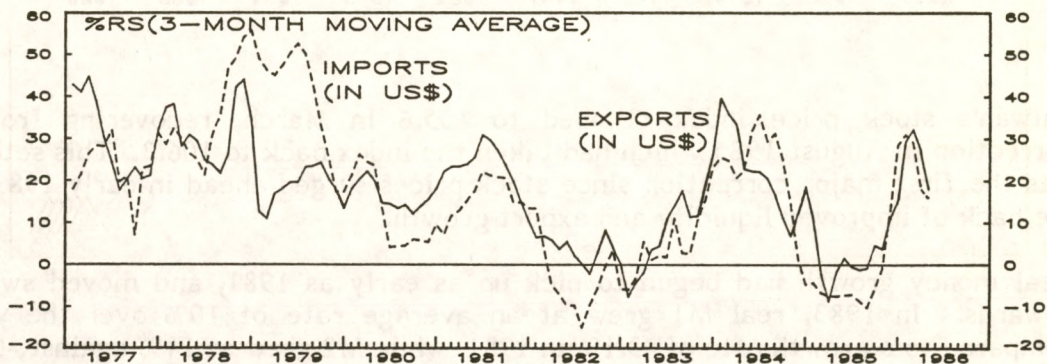
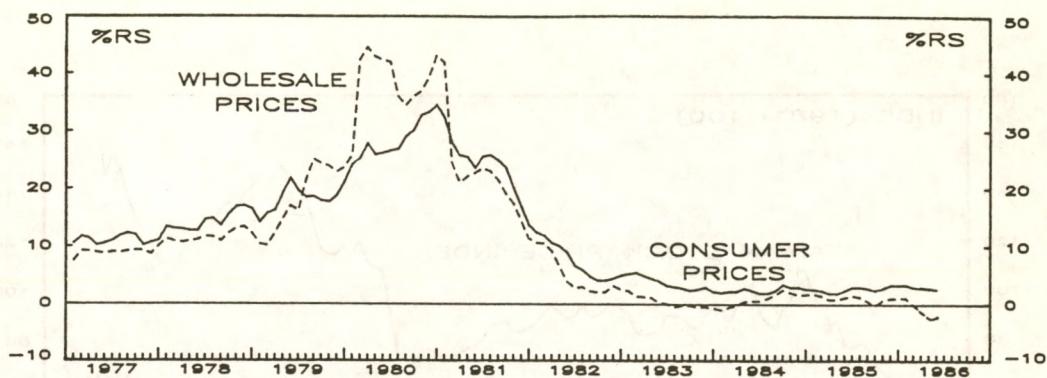


Korean equities have made huge price gains since October 1985, the Korean stock price index soaring by 76% over the nine month period. Since the beginning of this year, the surge in stock prices has reflected a change in investor sentiment partly relating to the official decision to allow selected companies to issue convertible bonds, but also to the steadily improving economic picture which is showing the benefits of a lower exchange rate, controlled inflation and declining oil prices.

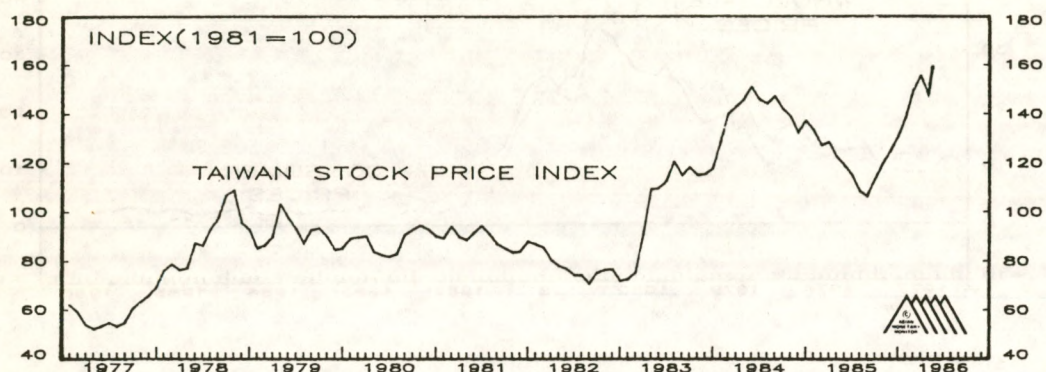
Both of the money aggregates M2 and M3 began to pick up during 1985. This trend has been sustained this year, with M2 increasing at a year-on-year rate of 17% in February, although M3 growth has slackened marginally - to a rate of 20% for the same month. The government's intention to significantly raise the monetary targets for this year, from 12-14% to approximately 18%, should underwrite this trend without fueling inflation, as price increases remain restrained. Wholesale prices fell by 2.4% in June from the year earlier month due to lower oil prices. In contrast, the CPI rose by 2.6% for the same month, as oil prices exert much less influence on this index. These low levels of inflation have aided competitiveness and significant growth in exports, which grew at a rapid rate of 25.5% year-on-year in 1986 Q1, although import growth has also increased similarly. The falling won exchange rate vis-a-vis the yen and other major currencies will help to sustain this trend and is already contributing to rising exports to the US, which increased by 26% over the five months of 1986.

The accumulation of evidence pointing to a rapidly strengthening economy has caused the government to revise its estimate for growth this year, from 7% to 8%, and this strength should underwrite the upward surge in the stockmarket.

THE REPUBLIC OF KOREA MONEY, OUTPUT, TRADE AND PRICES



TAIWAN'S STOCKMARKET RECOVERS ALONG WITH EXPORT AND MONEY GROWTH

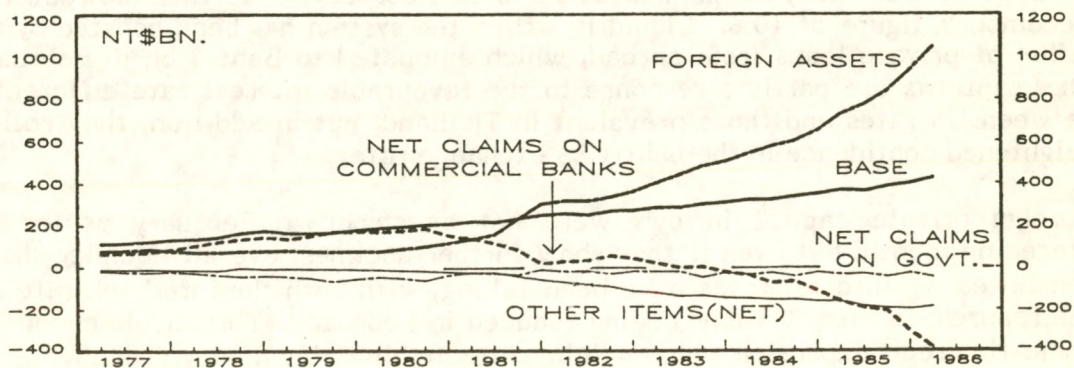
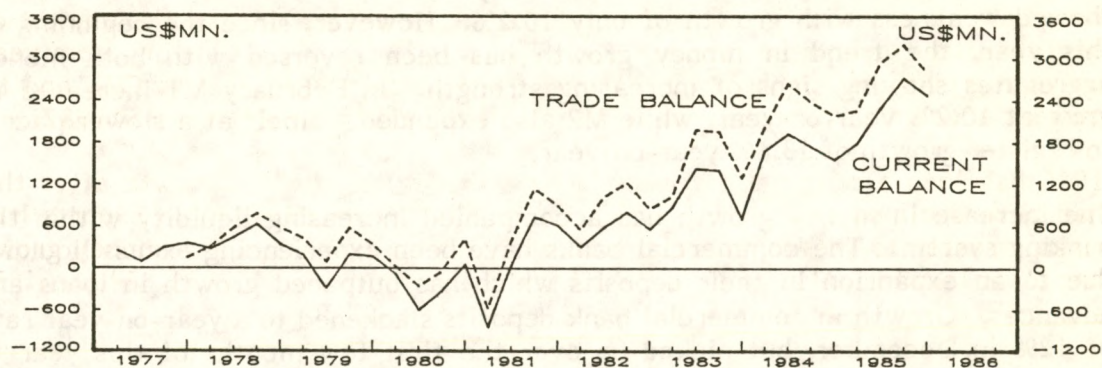
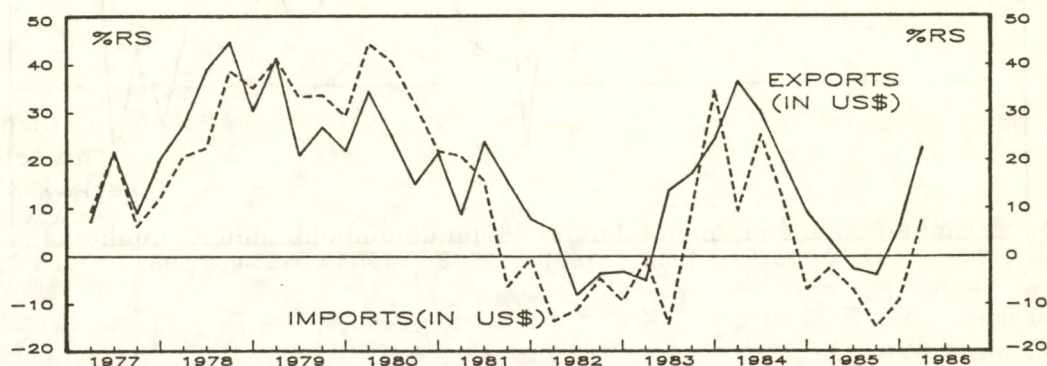
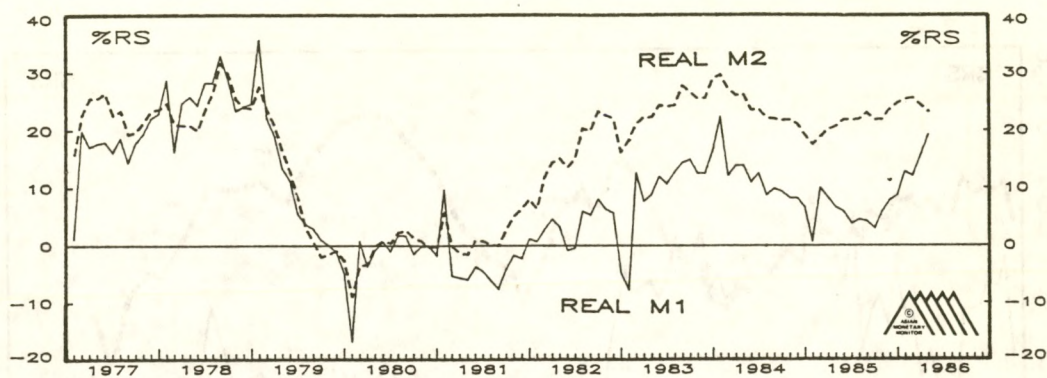


Taiwan's stock price index climbed to 155.6 in March, recovering from a correction in August 1985 which had taken the index back to 106.3. This setback was the first major correction since stock prices surged ahead in early 1983, on the back of improved liquidity and export growth.

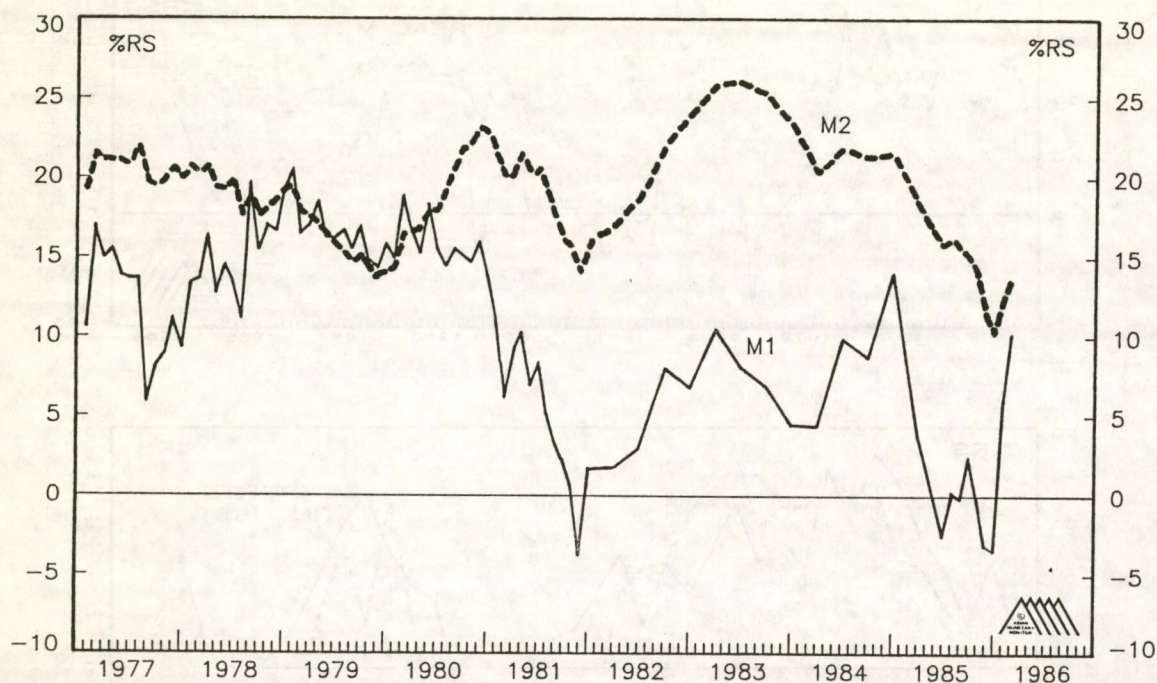
Real money growth had begun to pick up as early as 1981, and moved swiftly upwards. In 1983, real M1 grew at an average rate of 10% over the year, compared to a growth rate of -3.1% in 1981, while M2 grew at 24% against -0.7% for the same years. Yet liquidity alone was insufficient to drive the stockmarket, and an improvement in export performance and confidence was necessary to promote a sustainable rise in equity prices. Indeed the market did begin to rise when export growth changed direction in 1983, (moving from year-on-year growth of -5% 1983 Q1 to year-on-year growth of 14% in Q2), and the current account surplus rose to US\$4412 million, almost double that of 1982.

1986 has seen a renewed recovery in both money and export growth after they had both declined from their peaks of the first quarter of 1984. Exports have risen strongly to year-on-year growth of 22.6% in 1986 Q1, while money growth has also picked up, M1 growing at 16% year-on-year in March 1986. Although M2 showed a slight downturn for the same month it seems unlikely that this heralds a period of slowing money growth because the monetary base grew at a more rapid year-on-year rate of 16% in March, while foreign reserves grew at a rate of 44%, year-on-year for the same month. Rapidly growing foreign reserves are the result of the burgeoning current account surplus, and to offset their accumulation sales of treasury bills were sharply increased over the last quarter of 1985 and the first quarter of this year. So far Taiwan has taken only limited action to reduce the current account surplus by revaluing the exchange rate or by liberalising imports and capital outflows. Although the NT\$ has appreciated against the US\$ to move out of the range it traded in following the institution of the NT\$ float in 1982, the central bank has been attempting to limit the rise, despite the depreciation of the US\$ against other major currencies. If more decisive action is not taken, money supply is likely to balloon out of control and action will eventually be forced upon the Taiwan authorities. The beginnings of this are already being seen in the foreign exchange markets.

TAIWAN REAL MONEY, TRADE AND THE MONETARY BASE



THAILAND'S MONEY GROWTH TURNS UPWARDS

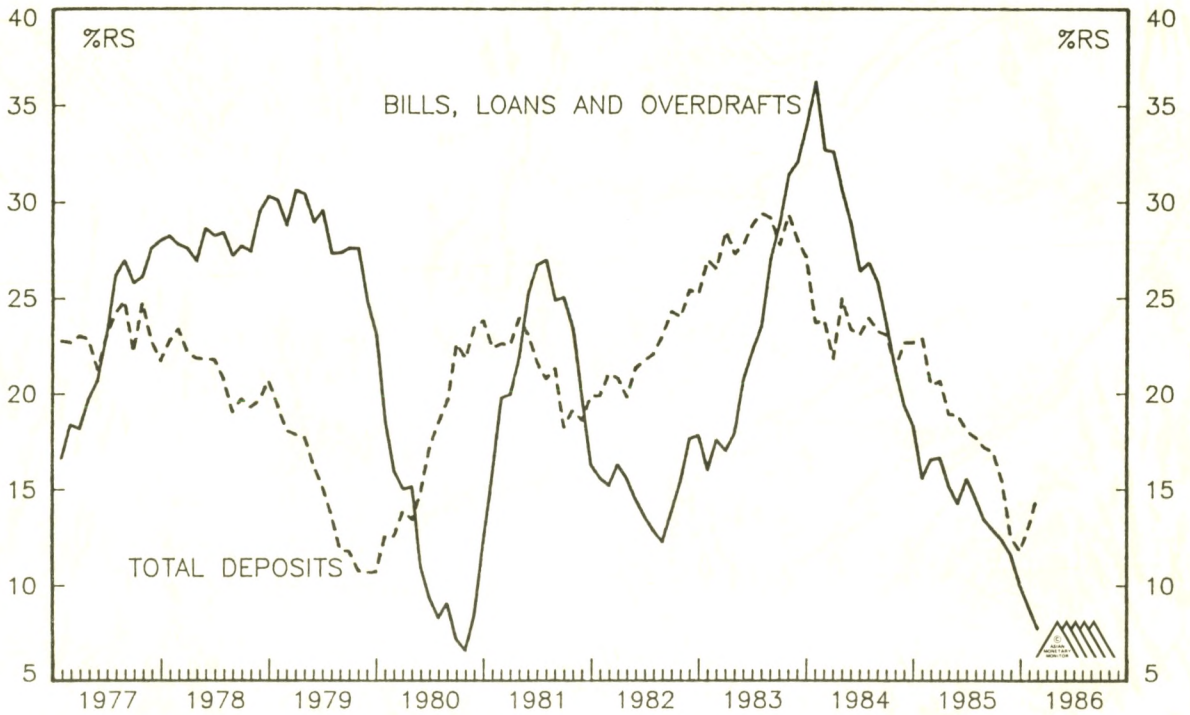


Money supply growth displayed a weakening trend over 1985, bottoming in December with M1 growing at -3.5% in year-on-year terms, while M2 also showed weakness with growth of only 10.2%. However, since the beginning of this year, the trend in money growth has been reversed with both money aggregates showing signs of increasing strength. In February M1 increased to grow at 10.2% year-on-year, while M2 also expanded - albeit at a slower pace - to register growth of 13.6% year-on-year.

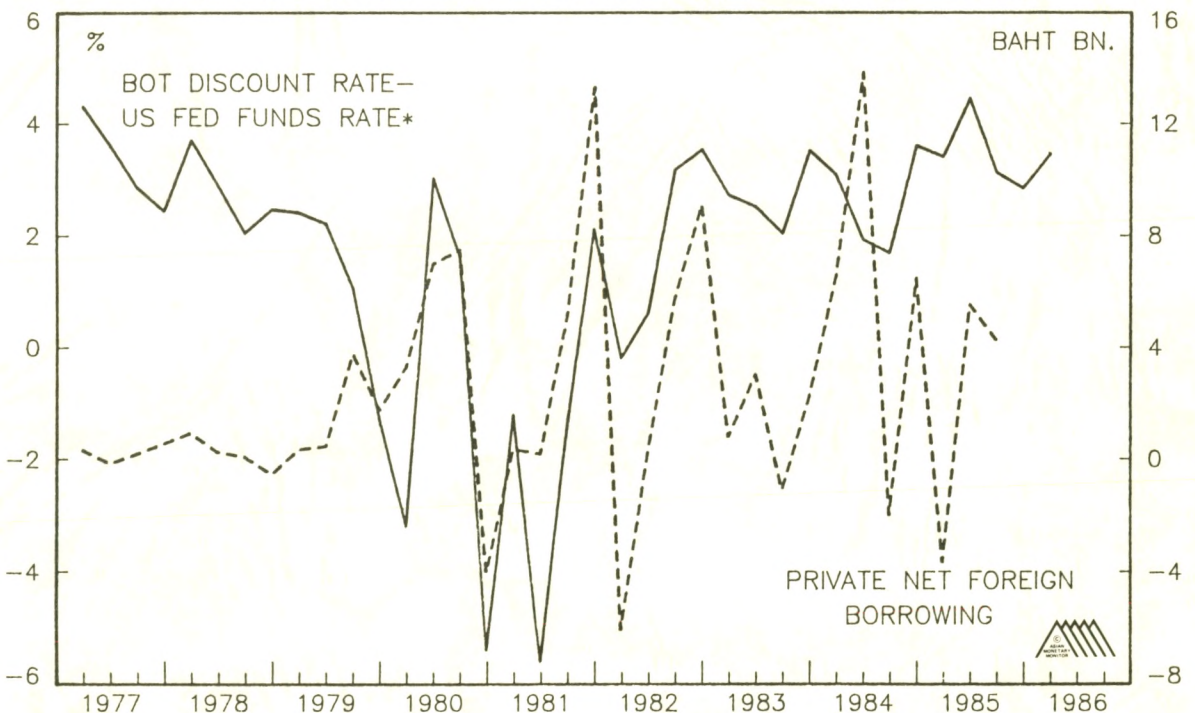
The increase in money growth has accompanied increasing liquidity within the banking system. The commercial banks have been experiencing excess liquidity due to an expansion in their deposits which has outpaced growth in loans and advances. Growth in commercial bank deposits slackened to a year-on-year rate of 12% in December, but picked up over the first few months of this year to stand at 14.7% in February. In contrast growth in commercial bank loans declined to year-on-year growth of 7.7% in February, a further slowdown on December's figure of 10%. Liquidity within the system has been boosted by the influx of private loans from abroad, which amounted to Baht 4 bn in February. These inflows are partly a response to the favourable interest rate differential between US rates and those prevalent in Thailand, but in addition, they reflect heightened confidence in the baht/US\$ exchange rate.

Foreign private capital inflows were not as strong in February as for the preceding month, but even if they show further declines, overall liquidity should remain easy. Interest rates have been falling, with both the interbank rate and the repurchase rate (1-3 days) being reduced in February. This should encourage domestic credit expansion which will be reflected in rising money growth.

THAILAND BANK LOANS AND DEPOSITS



THAILAND INTEREST RATE DIFFERENTIAL AND CAPITAL INFLOW

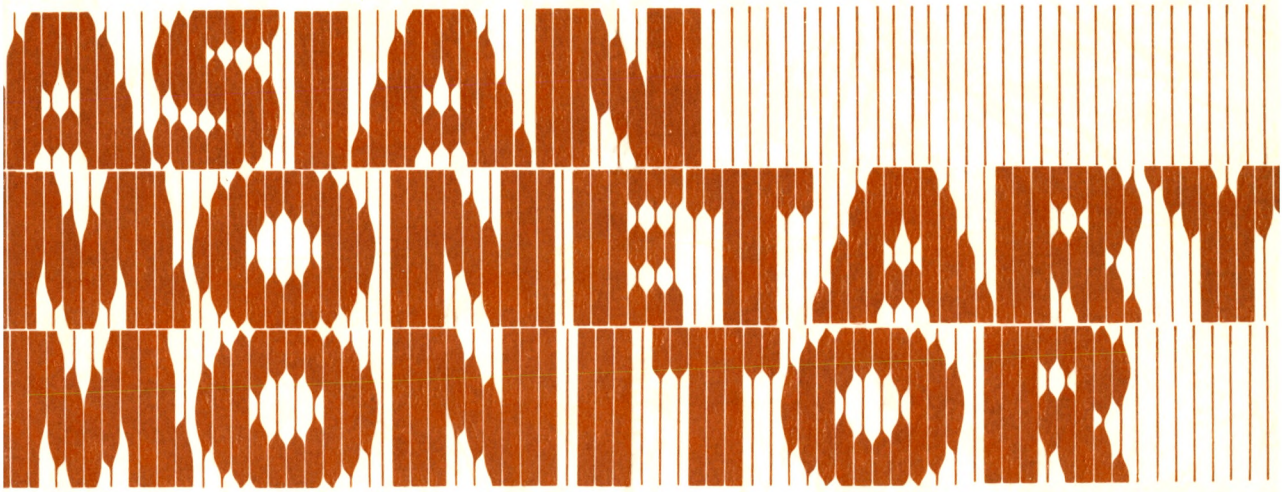


THESE RATES ARE NOT COMPARABLE HENCE ONLY THE TREND IN THE DIFFERENTIAL IS SIGNIFICANT



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KEYS TO SYMBOLS USED IN THE CHARTS

% RP	— Percentage Rate of change over Preceding period.
% RS	— Percentage Rate of change over Same period of preceding year.
SA	— Seasonally Adjusted.
SAAR	— Seasonally Adjusted at Annualised Rate.

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HONG KONG

THE HANG SENG INDEX FUTURES MARKET

On May 6, 1986, the Hong Kong Futures Exchange (HKFE) began trading futures contracts on the Hang Seng Index. In the short time that the index future has been trading, it has shown promise of revitalising the exchange and of adding an important new dimension to the stock trading environment in Hong Kong. The introductory section of this article briefly explains the contract specifications, mechanics of trading and uses of Hang Seng Index futures. The second section examines in detail the efficiency of the Hang Seng Index futures market to date, specifically with respect to a cash-and-carry arbitrage relationship and an equivalent portfolio valuation relationship.

1. Introduction

The Hang Seng Index (HSI) is a Laspeyres-type (i.e. base year weighted) index composed of 33 major Hong Kong stocks traded on the Hong Kong Stock Exchange. Although weights of individual issues vary as relative market prices change, the largest 9 companies comprise about 70% of the index. The HKFE stock index futures contract is based on the HSI. The contract calls for cash settlement of positions held to maturity, instead of actual delivery of a bundle of stocks. The price for cash settlement is the closing quotation of the Hang Seng Index on the last day of futures trading.

The value of the HSI futures contract is HK\$50 times the index and trading hours are 10.00 am-12.30 pm and 2.30 pm-3.30 pm. Contracts traded have in practice been the spot month and the next two months, although the exchange can alter this pattern. The minimum price fluctuation ("one tick") is one index point, and the daily allowable price limit is 100 points. All trades are cleared through the International Commodity Clearing House. The Hong Kong Commodities Guarantee Corporation Ltd., which has a paid up capital of HK\$15,000,000, stands behind all trades.

Margin requirements and a system of daily mark-to-market serve to assure that each trader makes good his obligations. Initial margin for retail customers is HK\$10,000, and maintenance margin is HK\$7,000. Margins must be deposited in cash. The member firms are required to post margin with the clearing house of HK\$3,000 cash for each contract traded. In practice, it appears that some large customers may be allowed by firms to post smaller margins, or to post them with securities rather than cash.

Futures commissions are also set by the exchange, at HK\$120 for a round turn intra-day trade, and HK\$200 for a round turn overnight trade. These too

are in practice discounted for large customers (30% is the "customary" discount). Currently, neither special spread margins nor spread commissions are permitted by the exchange. Thus, to trade a spread (short one month versus long a different month) a customer is required to post HK\$20,000 (i.e. \$10,000 for each contract). Since a spread position is typically less risky than an outright position, US practice is to require lower margins for spreads. The HKFE is considering reducing the spread margin to HK\$3,000, and reducing spread commissions to, perhaps, HK\$120.

Two trading methods are used on the floor at the HKFE. At the opening and the closing, a "group trading" or "chairman call" system is used. This is essentially an auction system. Typically, a very small amount of trading occurs under this system. After the chairman call session, the open outcry method is used. Most trading takes place using the open outcry system. Under the open outcry system, traders deal directly with each other. The idea of open outcry is that all bids and offers will be heard by all traders in the pit, and the lowest offerers and highest bidders will therefore trade with each other. This will usually be the case, although it is possible that in extremely busy markets, trades will take place virtually simultaneously at slightly different prices. Floor brokers are either individual members or work for a firm which owns a membership. Either way, they should always be trying to get the best possible price, and it is this incentive which keeps the market competitive. Because the Chairman Call Session takes an indeterminate length of time, its use at the closing means that no one knows when the market will actually close. This makes it difficult to take customer orders to be executed "at the close".

Because the market is so new, no official profile of market use exists. However, the biggest traders, on a daily volume basis, are probably Sun Hung Kai and Chin Tung, each of whom trades several hundred contracts per day. Of this volume, a large part is thought to be in-house trading. James Capel, Jardine Fleming, and Vickers da Costa each trade in the neighbourhood of one hundred contracts per day. This activity is thought to be largely arbitrage. There are also large local position traders, who take large speculative positions, sometimes hundreds of contracts which they hold overnight or longer, and in addition, there appears to be growing speculative participation by small local traders. Also, some London market makers in Hong Kong stocks are using the Hang Seng Futures Contract to hedge their inventories. The large premiums at which futures have been trading has made this a particularly attractive option. Such hedging use is likely to grow as more potential hedgers become familiar with the index futures market and as the futures market grows and offers more liquidity. There has not been a real bear market since the HSI futures started trading but if/when a bear market occurs, the futures market will provide a convenient and inexpensive (in transaction costs) method of shorting the market. Currently it is illegal to short the cash market (although some large traders are believed to do it nonetheless).

Liquidity on the HSI futures has grown well in the first two months of trading. Daily volume is currently about 2,000 contracts, and open interest at the end of June was slightly greater than 2,000 contracts. Daily volume is approximately one-half the daily dollar volume of the cash market. The majority of volume (perhaps 70%) on any day tends to be in the spot month, but the back months also have significant volume. Spreads between different futures contract

Arbitrage Example (With Full Retail Commissions)

Using July 9 closing prices for HSI and September futures contract

	Price	Value (Index x \$50)
Spot Index:	1,747	87,350
September Future:	1,814	90,700

Cost of Cash = 87,350
+ buying Commission at .825% = 87,350 + 720
= 88,070

Plus Cost of Carry for 2 2/3 months @ 8%
 $88,070 \times .08 \times \frac{2.67}{12} = 1,567.60$

Cost of Cash = 89,637
+ Selling Commission = 720 (assuming no price change)
Net Cost = 90,357

Proceeds from Futures = 90,700
- Commissions = 200
= 90,500

Net Profits = 90,500 - 90,357 = \$143

Annualised Return on Margin of 10,000
 $\frac{143}{10,000} \times \frac{12}{2.67} = 6.4\%$

maturities have not shown any particular patterns of behaviour, although they have not been as stable as one would expect to find in a pure carrying charge market. This instability is probably a result of unfamiliarity with futures, and seems to be diminishing with time. The futures-cash relationships, on the other hand, have consistently shown premiums significantly in excess of carrying charges. The premium implicit on the nearby future-cash basis has been in excess of 14% annualised for most of the time that the futures have been trading. With short term money market rates in the neighbourhood of 7%, this price structure is clearly inefficient. However, the retail customer cannot profit significantly from this arbitrage opportunity because retail commissions approximately exhaust the available profits (see Box).

Several market participants and observers have alleged various types of manipulation involving the HSI futures contract. The schemes essentially consist of taking a futures position just in advance of a large cash market transaction which the "manipulator" expects to move the market. One example might be a fund manager who plans to sell off a significant part of his portfolio. Knowing that how he places the stock for sale may affect the market price, he could short futures, then carefully sell off most of what he wanted to sell, without depressing prices very much. He could then dump the remainder on the market with the intention of driving prices down. At this point, he would cover his futures position. However, since this transaction is very similar to a hedge

transaction, in this case it is not clear whether or not it would be appropriate to call it manipulation. The answer may depend on the intentions of the seller.

2. The Pricing of Hang Seng Index Futures

2.1. The Cash-and-Carry Arbitrage Relationship

The ideal futures market cash-and-carry arbitrage transaction consists of buying a cash asset while simultaneously selling a futures contract for that asset. The arbitrage can be unwound either by simultaneously offsetting the cash and futures positions, or by delivery against the futures contract. The reverse of this arbitrage, selling short the cash asset and buying the futures contract is not generally possible in the Hang Seng Index futures market because cash market short sales are illegal. Thus, cash-and-carry arbitrage can provide a theoretical maximum futures price, but not a minimum price.

In practice, the HSI cash-and-carry arbitrage diverges from the described ideal in two major ways. First, the index itself is not a single asset that can be purchased as such - it must be constructed or synthesised with a portfolio of stocks. Not all the stocks that compose the HSI are sufficiently liquid to be purchased as part of an arbitrage program. However, it is practical to construct a portfolio of stocks whose aggregate price performance is very highly correlated with the actual index. Second, since the contract calls for cash settlement instead of actual delivery, stocks must be sold into the market to liquidate the arbitrage position. In practice, these sales will take some time, perhaps an hour during the last trading day on the futures contract. Thus, the arbitrageur will have a net short exposure for a brief period before the contract expires. However, these deviations do not appear to present very serious practical problems, except as far as they may limit the scale on which such arbitrage can occur.

In an efficient market, arbitrage profits will not be available. This bound can be found as follows:

$$(1) \quad \text{Arb Profit} = \text{PF} - \text{PS} - [\text{Transaction Cost} + \text{Carry Cost} + \text{Margin Cost} - \text{Expected Dividend Payments}]$$

where PF is the futures price and PS is the spot price of the index.

If we assume that markets are efficient, then arbitrage profits will be non-positive i.e. $\text{Arb Profit} \leq 0$

Rewriting (1) and including the relation that arbitrage profits are less than or equal to zero in efficient markets, we have

$$0 \geq \text{Arb profit} = \text{PF} - \text{PS} - [\quad]$$

$$0 \geq \text{Arb profit} = \text{Spread} - [\quad]$$

$$0 \geq \text{Spread} - [\quad] = \text{Arb profit}$$

Focussing on the inequality relationship we observe:

$$0 \geq \text{Spread} - [\quad]$$

$$\text{or } [\quad] \geq \text{Spread}$$

$$\text{i.e. (2) Transaction Cost} + \text{Carry Cost} + \text{Margin Cost} - \text{Expected Dividend Payments} \geq \text{Spread}$$

As the contract nears maturity, Carrying Cost, Margin Cost and Expected Dividend Payments tend to zero. However in Hong Kong, taxes represent an unavoidable element of arbitrage transactions costs. Thus, it is evident from (2) that cash-and-carry arbitrage cannot force the futures and cash prices to converge as the contract matures. Instead, as contract maturity approaches, (2) converges to:

$$(3) \text{ Spread} \leq \text{Transactions costs} > 0 \quad \text{or, rearranging}$$

$$(4) \text{ Transactions Costs} \geq \text{Spread} > 0$$

This cash-and-carry arbitrage is not entirely risk free due to the element of variation margin risk. However, in practice this is probably small, and may be ignored in this context. Variation margin risk and its treatment are discussed more fully later in this study.

It is thus necessary to look elsewhere for market forces which cause futures and cash prices to converge at maturity of the futures contract.

2.2. The Equivalent Portfolio Approach

The existence of the Hang Seng Index futures market offers investors two potential methods of investing in the Hang Seng Index. They can either buy a portfolio of stocks equivalent to the index or they can buy the index futures contract and invest the difference between the futures margin and the value of the cash portfolio in money market instruments.

The theoretical price for a forward contract on the index, in the absence of transactions costs, would be:

$$(5) \quad P_{\text{fwd}} = PS (1 + i - d)$$

where P_{fwd} is the forward price, PS is the spot price,

i is the interest rate (T-bill rate), and

d are the dividends expected to be paid over the holding period, with both i and d expressed at an annual percentage rate

The portfolio of stocks would then be exactly equivalent to a portfolio consisting of a forward contract and (for example) T-bills. However, a futures contract differs from a forward contract in two ways which are relevant here. Firstly, futures contracts require the posting of initial margin in cash and secondly, futures involve variation margin risk. Variation margin risk arises from the fact that futures are settled daily on a mark to market basis. Losses on futures positions must be paid in cash and gains are available in cash, also on a daily basis. Thus, if an investor holds a portfolio consisting of T-Bills and an

index futures contract, in a rising market the increase in equity will be available for reinvestment daily. Similarly, decreases in equity resulting from market declines must be paid daily, reducing the amount of cash available for T-bill investment and hence reducing investment income.

If the time series of equity prices is stationary (i.e. it returns to its mean) and is expected to remain stationary and also interest rates are negatively correlated with equity prices, then it can simply be shown that the expected value of net variation margin cash flows would be negative (Fabozzi & Kipnis, p. 87). This would imply that the theoretical futures price should be below the theoretical forward price. However, if the market is expected to trend upward over the long-term investors might not perceive the expected value of variation margin risk as negative, and may in fact perceive it as positive. Over the short term (i.e. within 3 months or the maturity period of the most distant futures contract), if stock prices move randomly and independently of interest rates, the expected value associated with variation margin risk will be zero. This would imply that theoretical futures prices equal theoretical forward prices, with an adjustment for initial margin costs. Thus, the theoretical futures price would be:

$$(6) \quad PF = PS (1 + i - d) + M \quad \text{where}$$

M = opportunity cost of margin

However, as is clear in the case of the cash-and-carry arbitrage, transactions costs are another important factor in determining theoretical price relationships, although transactions costs present some analytical difficulties in calculating theoretical futures prices on an equivalent portfolio basis. The difficulty stems from the fact that transactions costs for futures are relatively low, but recurring, while transactions costs for cash securities are relatively high, but non-recurring. Therefore, the appropriate level of futures transactions costs depends on how long the portfolio is to be held. One approach has been to assume transactions costs are zero (see for example Fabozzi and Kipnis, p. 68). This, however, is not entirely satisfactory, especially in the Hong Kong market where, as has been shown, the existence of transactions taxes which are unavoidable - even by exchange members - means that cash-and-carry arbitrage cannot be counted on to bring cash and futures to convergence at maturity.

Since the futures contract transactions costs are recurring and the cash transactions costs are not, a standardised time period must be chosen against which to compare transactions costs. One month is convenient, although other lengths of time may be appropriate for different investors. This assumption about the holding period allows equation (6) to be rewritten as:

$$(7) \quad PF = PS (1+i-d)+M+T \times \frac{(\text{days to maturity})}{\text{standardised time period}}$$

where T = net transactions costs savings of futures relative to cash per standardised time period.

This formulation, despite its sensitivity to choice of the standardised time period, has the desirable property that PF converges to PS as contract maturity approaches.

Thus, equation (7) provides a second theoretical price. This price relationship holds with equality, whereas the arbitrage relationship held only as an upper bound. In practice, however, this formula may provide a reliable guide to price only when the contract is very close to expiration and the coefficient of T is known to be close to zero. At other times, the differing values that different investors place on that coefficient will mean that no unique relationship is valid for all investors. Furthermore, because equation (7) only establishes the value of a futures contract versus the cash market on an equivalent portfolio basis, it would not be expected to hold when it was inconsistent with cash-and-carry arbitrage. Since the cash-and-carry arbitrageur can earn risk free profits by arbitrage, that process should, in an efficient market, hold the futures-cash basis down regardless of what other higher valuations investors may place on the futures relative to cash.

2.3 Empirical Analysis

As with most empirical work, there are important issues relating to sources and choices of data. With respect to some data, it is not always absolutely clear which figures are appropriate. In these cases, the choices of data may affect the findings of the study. The futures prices used in the present study are daily settlement prices supplied by the Hong Kong Futures Exchange. The prices of the cash index were supplied by HSI Services Ltd., the subsidiary of the Hang Seng Bank which calculates the index. The figures used were afternoon closing prices, rounded off to the nearest integer. Estimates for the level of bid-ask spread which would be faced by arbitrageurs in the cash market were supplied by market participants. There was not much uncertainty expressed by participants about the magnitude of this spread. For the arbitrage calculation, commission charges are omitted under the assumption that least-cost arbitrageurs will be individuals or organisations that already own memberships on both the cash and futures exchange. Thus, marginal commission costs are effectively zero for this group. For the equivalent portfolio calculation, commissions are included for both cash and futures.

There are two main considerations in choosing an appropriate interest rate to use in calculating theoretical spreads. These are term or maturity (e.g. overnight or 3 month rates?) and credit rating (e.g. risk free rate, or higher?). The large brokerage firms, which should be the least-cost arbitrageurs, have access to credit markets at near risk free rates. During the period of this study, short term interest rates - overnight, one month and three months in both US dollars and Hong Kong dollars, have all been quite steady, and within about $\frac{1}{2}\%$ of each other at between 7 and $7\frac{1}{2}\%$. On this basis, and on the basis of observed practice, 7% has been used as the interest rate in this study. This rate is also used as representative of opportunity cost for the equivalent portfolio calculations. Dividends are another important element which affect the return to cash-and-carry arbitrage. It is expected dividends which are factored into the arbitrageur's decision. Firms typically announce their dividend payment plans in advance, as well as the payment dates. As firms usually fulfil these plans, expected dividends for a portfolio of stocks tend to be very close to actual dividends over short periods. During the period covered in this study, the dividend yield on the HSI has averaged approximately 4% per year. In an informationally efficient securities market, expected dividends will accrue in the price of a stock until dividends are actually paid. However, since dividends are

not paid on futures contracts, only those expected dividends which will not have been paid by the time the futures contract matures should be reflected in the futures price.

The maximum theoretical premium of futures over cash based on cash-and-carry arbitrage was calculated using the following equation (from equation (2))

$$\text{Max Spread} = \underset{(a)}{0.0135 \text{ PS}} + \underset{(b)}{0.07 \text{ PS} \times \text{AF}} + \underset{(c)}{0.07 \times \text{AF} \times 60} - \underset{(d)}{\text{EDP}}$$

where:

(a) PS is the value of the cash index

Fixed transaction costs of 1.35% are composed of the following:

1. 0.3% stamp duty on buying and selling.

Assuming the selling price is the same as the buying price then, $2 \times 0.3\% = 0.6\%$

2. 0.025% transfer tax on buying and selling ($2 \times 0.025\% = 0.05\%$)

3. 0.7% bid-ask spread incurred in buying and selling the cash securities

b) AF is an annualisation factor equal to the number of days to maturity divided by 365. The 7% interest rate is used as previously explained.

c) The margin opportunity cost is based on \$3000 margin which must be posted in cash with the clearing house.

$$60 = \frac{3000}{50} \text{ which adjusts for the contract size (i.e. \$50 x index)}$$

d) EDP is expected dividend payments between the current date and maturity of the futures contract, in terms of index points.

The equation for the theoretical equivalent portfolio price which was derived earlier (equation (7)) is

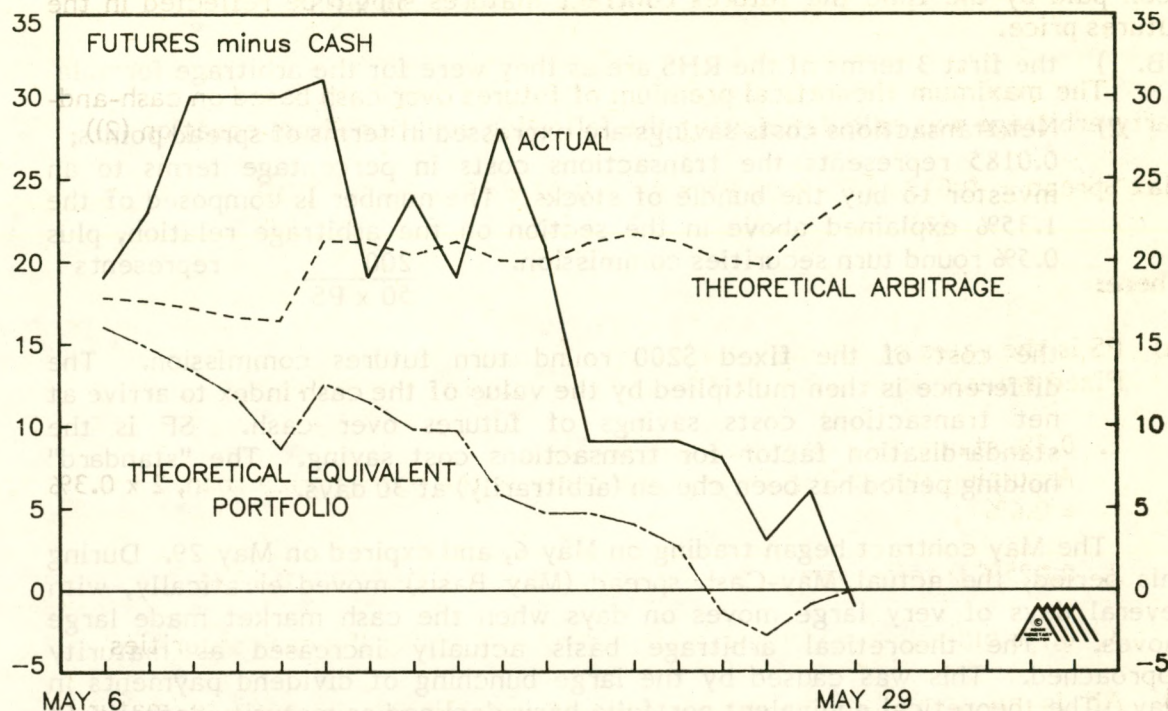
$$\text{PF} = \text{PS} (1+i-d)^{M+T} \times \frac{(\# \text{ days to maturity})}{30 \text{ days}}$$

In terms of the spread (i.e. PF-PS) this is:

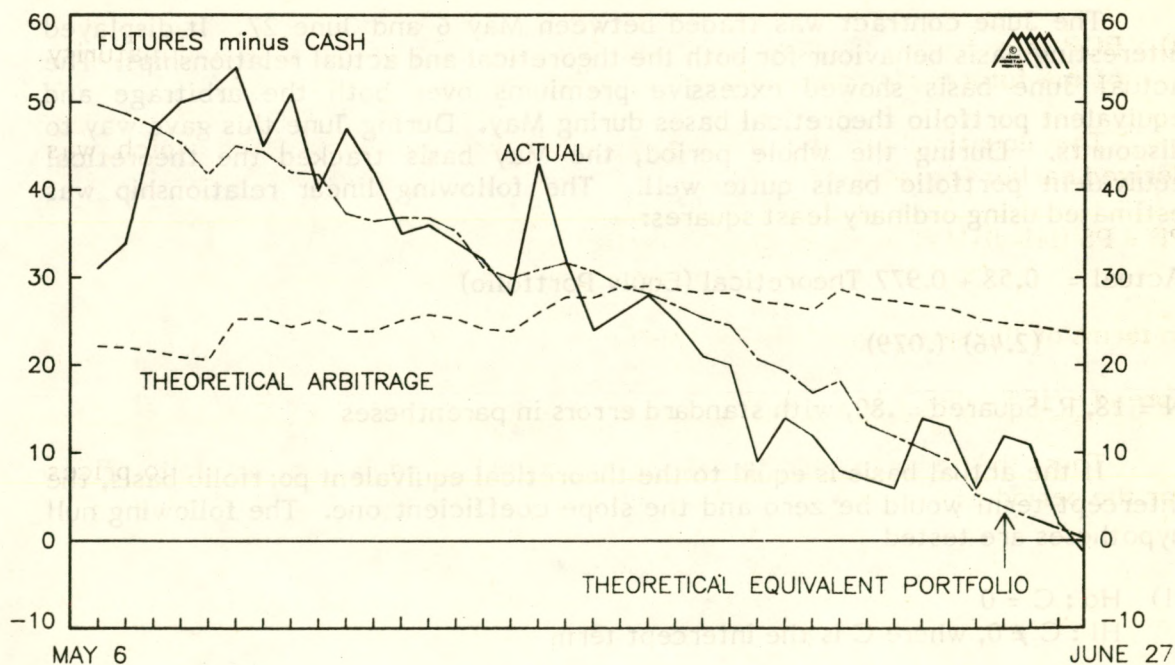
$$\text{Spread} = i\text{PS} - d\text{PS} + M + T \times \text{SF}$$

Thus, the formula used to calculate theoretical equivalent portfolio prices for the period is:

THE PRICING OF THE HANG SENG INDEX FUTURES CHART 1: MAY BASIS



THE PRICING OF THE HANG SENG INDEX FUTURES CHART 2: JUNE BASIS



$$\text{Spread} = 0.07 \times \text{PS} \times \text{AF} - \text{dPS} \times \text{AF} + 0.07 \times \text{AF} \times 60 + (0.0185 - \frac{200}{50 \times \text{PS}}) \times \text{PS} \times \text{SF}$$

- NB. 1) the first 3 terms of the RHS are as they were for the arbitrage formula
- 2) Net transactions costs savings are expressed in terms of spread points; 0.0185 represents the transactions costs in percentage terms to an investor to buy the bundle of stocks. The number is composed of the 1.35% explained above in the section on the arbitrage relation, plus 0.5% round turn securities commission. $\frac{200}{50 \times \text{PS}}$ represents

the cost of the fixed \$200 round turn futures commission. The difference is then multiplied by the value of the cash index to arrive at net transactions costs savings of futures over cash. SF is the standardisation factor for transactions cost saving. The "standard" holding period has been chosen (arbitrarily) at 30 days.

The May contract began trading on May 6, and expired on May 29. During this period, the actual May-Cash spread (May Basis) moved erratically, with several days of very large moves on days when the cash market made large moves. The theoretical arbitrage basis actually increased as maturity approached. This was caused by the large bunching of dividend payments in May. The theoretical equivalent portfolio basis declined as maturity approached and the time-weighted net transactions cost savings declined to zero. The actual performance of the May basis during May did not closely follow either the upper bound which arbitrage should impose, or the equivalent portfolio valuation. This probably reflects inefficiency, which would not be surprising in light of the newness of the market to Hong Kong and the consequent lack of familiarity with futures among traders.

The June contract was traded between May 6 and June 27. It displayed interesting basis behaviour for both the theoretical and actual relationships. The actual June basis showed excessive premiums over both the arbitrage and equivalent portfolio theoretical bases during May. During June this gave way to discounts. During the whole period, the May basis tracked the theoretical equivalent portfolio basis quite well. The following linear relationship was estimated using ordinary least squares:

$$\text{Actual} = 0.58 + 0.977 \text{ Theoretical (Equiv Portfolio)}$$

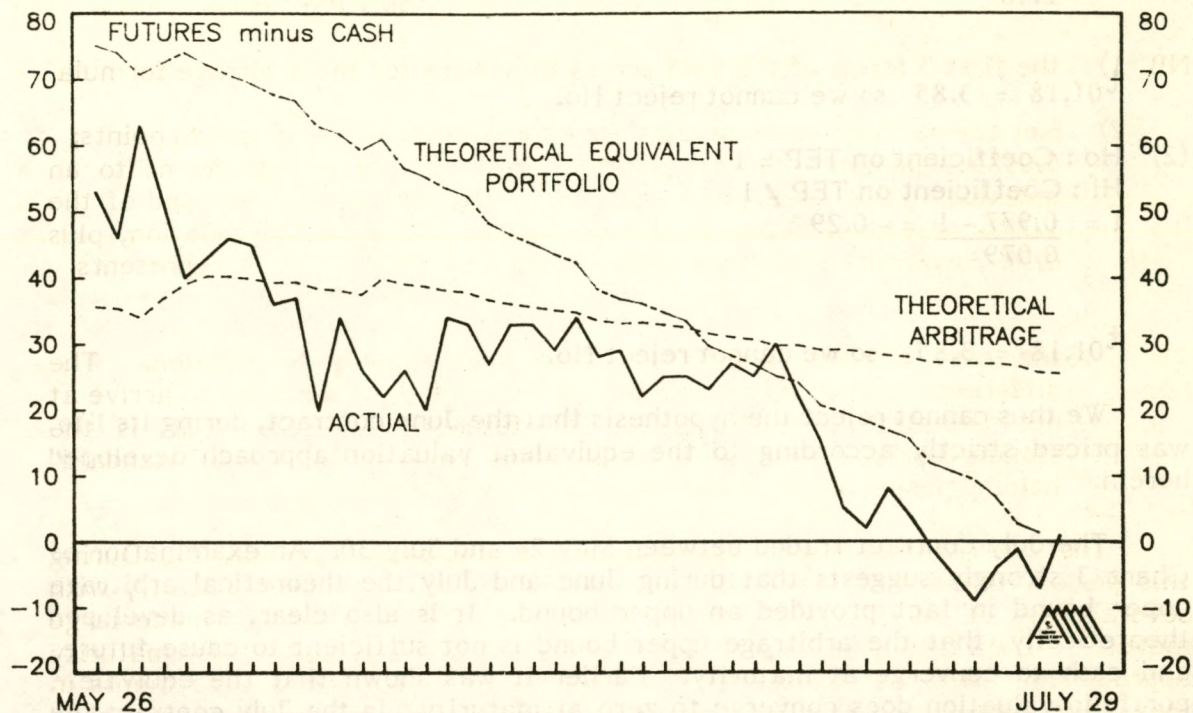
(2.46) (.079)

N = 18, R-Squared = .80, with standard errors in parentheses

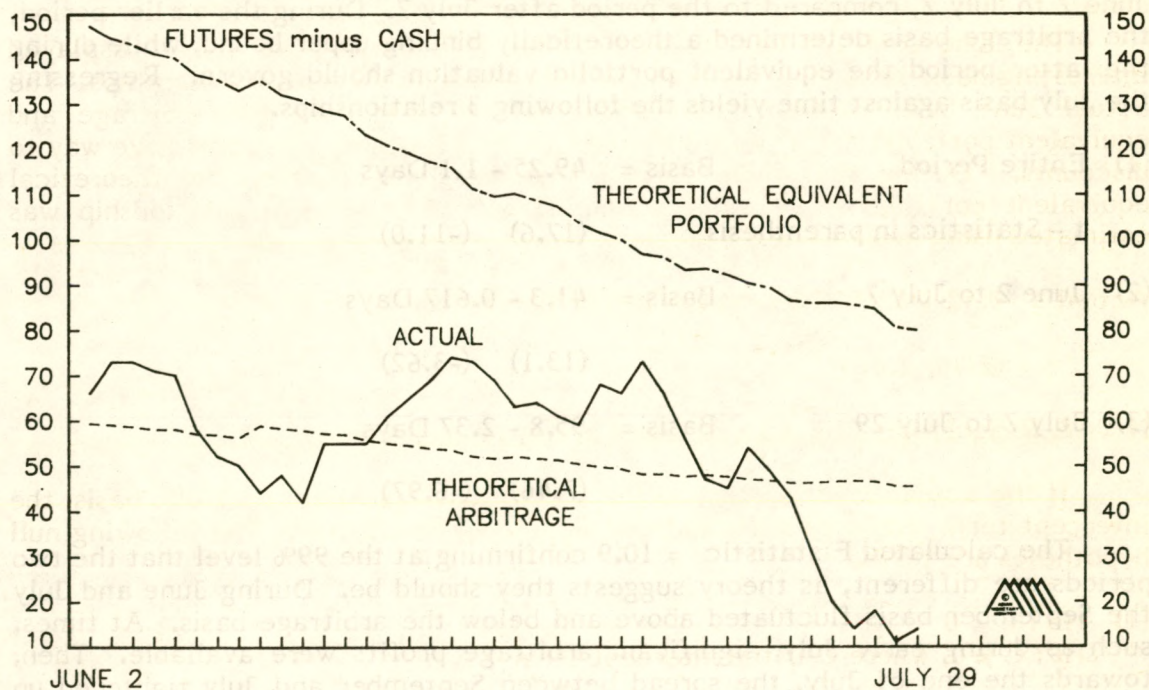
If the actual basis is equal to the theoretical equivalent portfolio basis, the intercept term would be zero and the slope coefficient one. The following null hypotheses are tested

- (1) $H_0 : C = 0$
 $H_1 : C \neq 0$, where C is the intercept term

THE PRICING OF THE HANG SENG INDEX FUTURES CHART 3: JULY BASIS



THE PRICING OF THE HANG SENG INDEX FUTURES CHART 4: SEPTEMBER BASIS



$$t = \frac{0.58-0}{2.46} = 0.24$$

$t_{01,18} = 3.85$ so we cannot reject H_0 .

(2) H_0 : Coefficient on TEP = 1

H_1 : Coefficient on TEP $\neq 1$

$$t = \frac{0.977 - 1}{0.079} = -0.29$$

$t_{01,18} = 3.85$ so we cannot reject H_0 .

We thus cannot reject the hypothesis that the June contract, during its life, was priced strictly according to the equivalent valuation approach developed herein.

The July contract traded between May 26 and July 30. An examination of Chart 3 strongly suggests that during June and July the theoretical arbitrage upper bound in fact provided an upper bound. It is also clear, as developed theoretically, that the arbitrage upper bound is not sufficient to cause futures and cash to converge at maturity. Earlier it was shown that the equivalent portfolio valuation does converge to zero at maturity. In the July contract the equivalent portfolio basis crossed the arbitrage basis on July 7. Three days later the actual basis reached the arbitrage basis for the last time before dropping quickly toward zero. This convergence coincides nicely with the theory presented, although the actual basis goes to large discounts to the equivalent portfolio basis before both converge to zero. A Chow test was used to determine whether the rate of convergence for the July basis was different in the period June 2 to July 7, compared to the period after July 7. During the earlier period, the arbitrage basis determined a theoretically binding upper bound, while during the latter period the equivalent portfolio valuation should govern. Regressing the July basis against time yields the following 3 relationships.

- | | |
|-------------------------------|---------------------------|
| (1) Entire Period | Basis = 49.25 - 1.1 Days |
| t - Statistics in parenthesis | (17.6) (-11.0) |
| (2) June 2 to July 7 | Basis = 41.3 - 0.617 Days |
| | (13.1) (-3.62) |
| (3) July 7 to July 29 | Basis = 95.8 - 2.37 Days |
| | (7.46) (-6.97) |

The calculated F statistic = 10.9 confirming at the 99% level that the two periods are different, as theory suggests they should be. During June and July the September basis fluctuated above and below the arbitrage basis. At times, such as during early July, significant arbitrage profits were available. Then, towards the end of July, the spread between September and July tightened up

considerably and the September basis declined sharply as the July basis converged to zero.

Conclusion

The observed behaviour of the basis relationships during the first three months of trading in Hang Seng Index futures indicates that futures have often shown excessive premiums making arbitrage profits available. The market thus has not been efficient from a cash-and-carry arbitrage point of view. There is some evidence that the market may be moving in the direction of arbitrage efficiency. All three contracts that traded during May - May, June and July - showed arbitrage inefficiencies during that month. During June, only the September contract showed arbitrage inefficiencies, and these disappeared during July. In the presence of unavoidable costs, such as taxes on cash securities transactions, arbitrage cannot force convergence of futures and cash. The behaviour of the June and July bases as these contracts matured support the hypothesis that the theoretical equivalent portfolio valuation, instead of arbitrage, governs the convergence of cash and futures.

Reference:

Fabozzi, Frank J. and Kipnis Gregory M., Eds. Stock Index Futures, Homewood, Illinois: Dow Jones Irwin, 1984.

JAPAN

A LONG TERM PROJECTION FOR THE YEN-DOLLAR EXCHANGE RATE

In attempting to forecast the five-year trend in the yen-dollar exchange rate it was decided to proceed using a key premise. That assumption is that over the next five years, the yen-dollar exchange rate must adjust in such a way that both Japan's current account surplus and Japan's enormous net foreign assets are substantially reduced. There is abundant justification for this assumption. Only if Japan's very large current account surplus is reduced may one anticipate a reduction in protectionist sentiment in the US, an end to Japan's reliance upon export growth, and a more balanced global economic environment.

In the charts and text below we list a series of arguments why it will likely prove very difficult to reduce Japan's current account surplus without a further substantial appreciation in the yen-dollar exchange rate.

First, Japan's terms of trade are likely to undergo a sustained rise over the next five years. Japanese import costs in yen will fall more rapidly than export prices in yen. Therefore, Japan's exports must fall much more rapidly than imports if Japan's current account position is to return towards balance. Thus, the forthcoming rise in Japan's terms of trade implies that to achieve equilibrium in Japan's current account will require a stronger yen than would have been the case a year or two ago.

Second, despite the appreciation of the yen to date, we assert that Japan will remain very competitive in international trade. We believe that Japanese inflation will remain at lower levels than in the US, which implies that the "equilibrium" level of the yen-dollar exchange rate will continue to appreciate - to approximately Yen 140 by 1990.

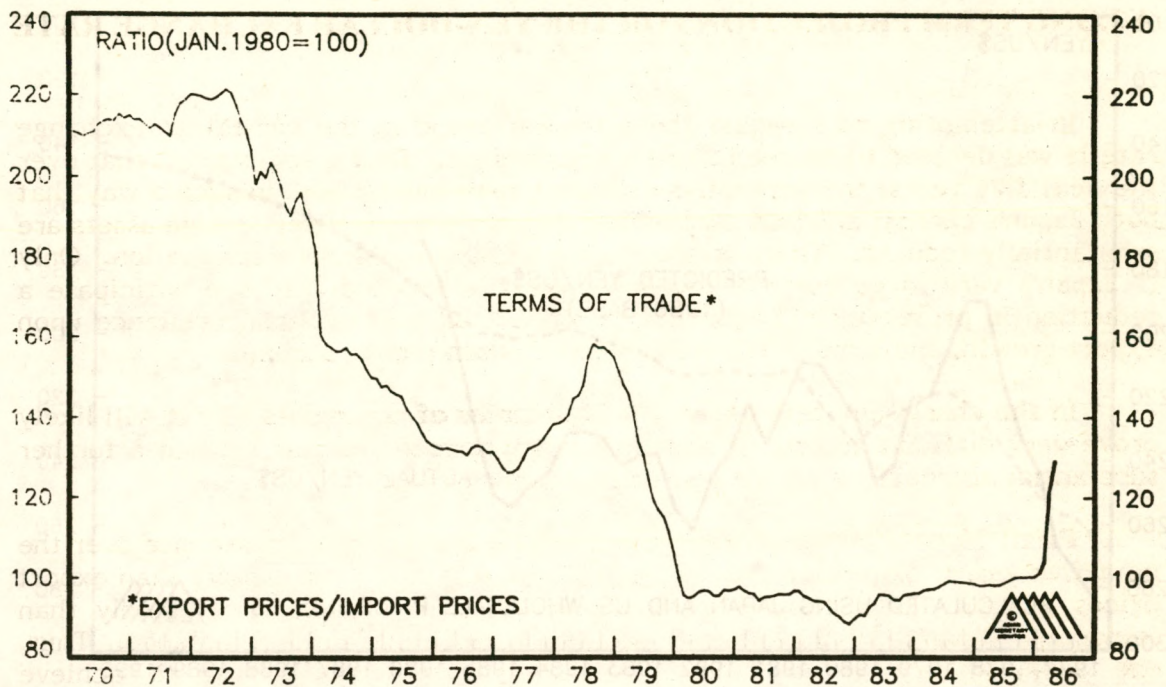
Third, however, it seems unavoidable that the yen must overshoot its "equilibrium" level if Japan's current account surplus is to be reduced significantly. A range of assumptions are listed below which demonstrate how difficult it is now for Japan to reduce its burgeoning net external surplus. Consequently a meaningful decline in Japanese net foreign assets will not occur until the yen appreciates towards the Yen 110 level.

Towards the end of the period under review there may be scope for a slight weakening in the yen against the dollar.

In addition, it is very important that investors do not underestimate the implications of the development of the yen as a reserve currency. If one allows for the possibility that the yen will emerge as an alternative reserve currency to the US dollar over the next five years, then one may predict strong growth in the demand for yen as a store of international value. If the development of international markets in the yen proceed more rapidly than we anticipate then the yen will likely appreciate to levels which exceed all expectations.

Chart 1 illustrates Japan's terms of trade - defined as the ratio of export

JAPAN: CHART 1 THE TERMS OF TRADE

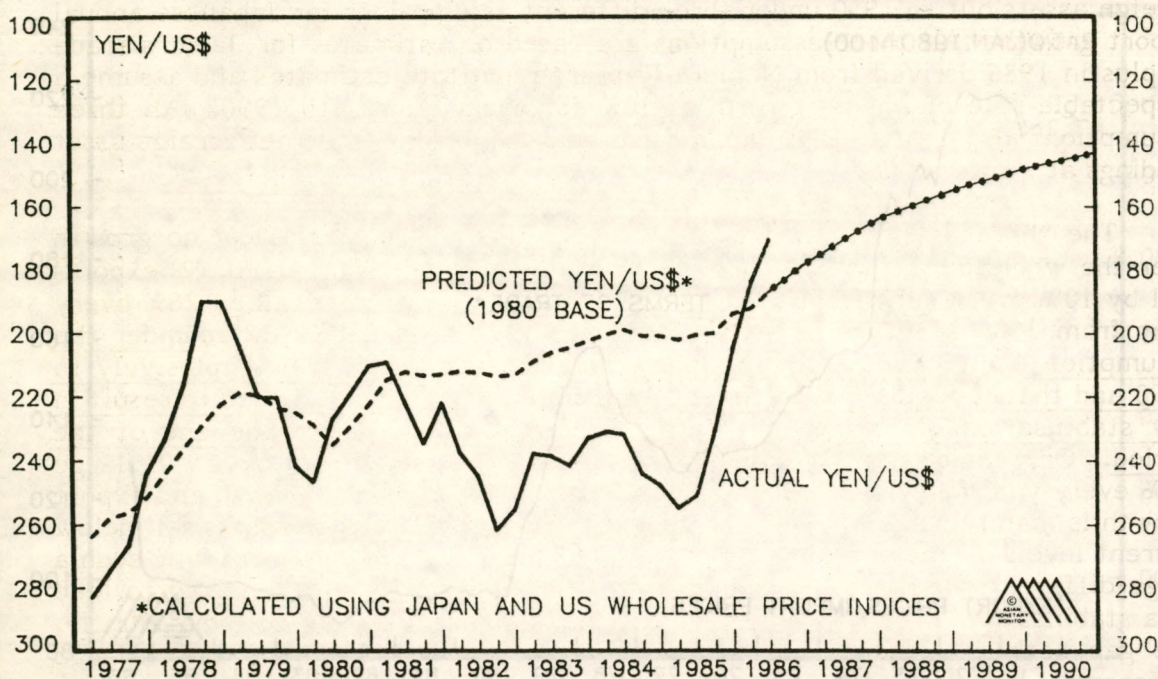


prices to import prices, both expressed in domestic currency terms - over the period 1970 to 1986. The dominating influence on Japan's terms of trade over the decade of the 1970s were the two commodity price surges of 1973-75 and 1979-80, both of which resulted in a rapid rise in Japanese import prices relative to export prices, and hence a sharp deterioration in the terms of trade on each occasion. As a result of the recent falls in commodity prices, and particularly the recent collapse in oil prices back to 1978 levels, as well as the recent appreciation of the yen, yen import prices are now declining and a significant part of the 1970's terms of trade deterioration can be expected to be reversed. This improvement in Japan's terms of trade means that Japan will be able to export less in order to pay for a given quantity of imports. However, because volume responses to sharp terms of trade changes take time to occur, the initial effect of the terms of trade improvement will be a further growth in Japan's trade surplus.

An improvement in Japan's terms of trade will, other things being equal, lead to a rise in Japan's trade surplus. This in itself is a powerful factor supporting a stronger yen. Over the longer term, a rise in the terms of trade implies that there is less requirement that Japan has strong export growth in order to achieve balance in the trade account. Thus with rising terms of trade the yen will generally be stronger than would otherwise be the case.

Chart 2 compares the actual yen/US dollar rate with the rate predicted by purchasing power parity (PPP) theory (i.e. the exchange rate between the yen and US dollar which would act to maintain the relative international competitiveness of Japan and the US at the same level as existed at a given base

JAPAN: CHART 2
PREDICTED YEN/US\$ RATE USING PURCHASING POWER PARITY



date (in this case 1980), given the relative inflation performance of the two countries). Over very long periods of time currencies tend to fluctuate around their purchasing power parity levels because if the prices of goods produced in country A rise relative to the prices of goods produced in country B then residents of country A will tend to purchase the relatively cheaper goods produced by country B, leading to a deterioration in country A's trade balance which should ultimately weaken its currency to the point where its international price competitiveness is restored. However, as is well-known, currencies can deviate substantially from purchasing power parity levels for periods of up to several years because, in the shorter term, exchange rates are not only determined by trade flows but also, importantly, by capital flows. In practice, currencies tend to move in cycles of 'overshooting' and 'undershooting' their purchasing power parity levels.

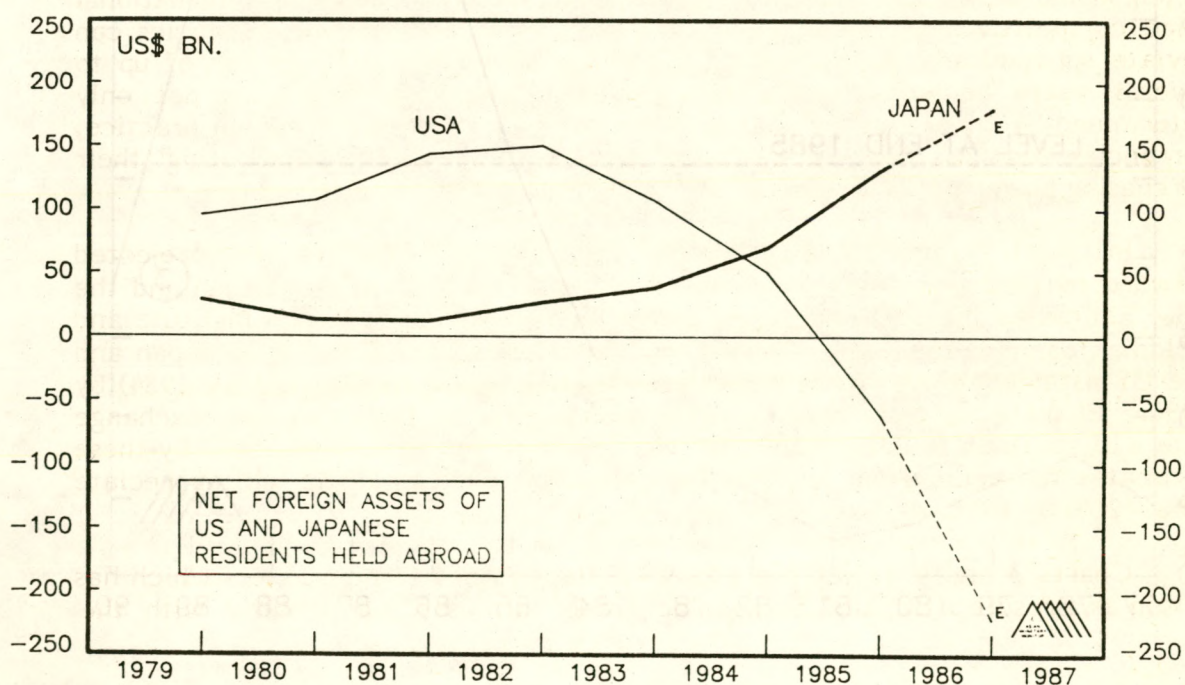
In Chart 2 the PPP level for the yen/US dollar rate has been projected forward to 1990 using forecasts for wholesale price inflation in Japan and the US. Estimates for 1986 are based on those of Nomura Research Institute and Goldman Sachs respectively, with the inflation differential between Japan and the US assumed to return to its historic average level (3.5% for 1974-1984) by 1990. Chart 2 suggests that the equilibrium level of the yen-dollar exchange rate will continue to appreciate over the course of the next five years. By these estimates the equilibrium level of the yen-dollar exchange rate will appreciate 15% - 20% by 1990.

Charts 3 and 4 depict the growth in Japan's net foreign assets which has arisen as a result of Japan's burgeoning trade surpluses, particularly with the

US. Chart 3 shows Japan, now the world's largest creditor nation, in comparison with the US, now the world's largest debtor nation. Chart 4 projects Japan's net foreign assets out to 1990 under three different assumptions for Japanese annual export growth. All three assumptions are based on estimates for Japan's trade surplus in 1986 derived from Nomura Research Institute estimates and assume a respectable rate of import growth of 10% for every year until 1990. All three assumptions also assume that Japan earns annual interest on its net foreign asset holdings at a rate of 7%.

The three assumptions are respectively that (1) exports show no growth over the whole period to 1990 (i.e. they remain flat at 1986 levels), (2) exports fall by 10% every year from 1987 to 1990 inclusive, (3) exports fall by 20% every year from 1987 to 1990 inclusive. The projections show clearly that under the assumption of no export growth, Japan's net foreign assets grow explosively to 1990 and that it requires a persistent negative rate of export growth to result in any stabilisation of Japan's net foreign asset position before the end of the period. Only under the third assumption - that exports contract by a very large 20% every year and thus that the differential between import growth and export growth is maintained at 30% every year, do Japan's net foreign assets fall below current levels by the end of the period. There are two basic reasons why such a large differential between import growth and export growth is required to lead to a stabilisation of Japan's net foreign asset position in the projections. Firstly, the gap between Japanese exports and imports is now so large that a large differential between import growth and export growth is needed to eliminate the trade surplus. Secondly, the longer that it takes for Japan's trade surplus to be reduced, the more difficult it becomes to stabilise the net foreign asset position because the net foreign assets themselves become capable of providing large foreign exchange earnings (in the form of investment income) to Japan. This is

JAPAN: CHART 3
THE US AND JAPAN: DEBTOR AND CREDITOR NATIONS
NET ASSETS OF US AND JAPANESE RESIDENTS HELD ABROAD



JAPAN: CHART 4

PROJECTIONS FOR JAPAN'S NET FOREIGN ASSETS UNDER DIFFERENT ASSUMPTIONS FOR EXPORT GROWTH

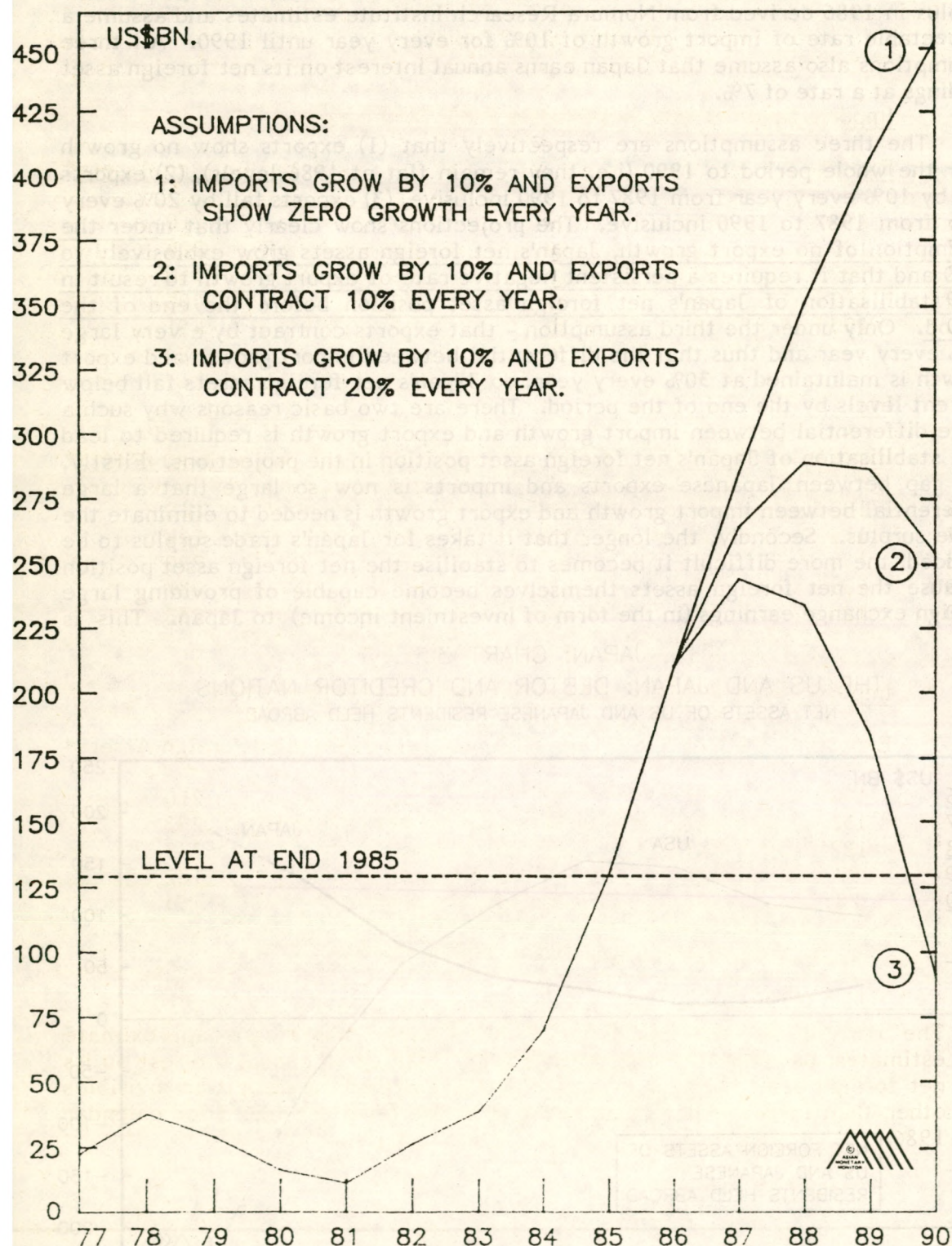


TABLE 1

PROJECTIONS FOR JAPAN'S NET FOREIGN ASSETS UNDER DIFFERENT
EXPORT GROWTH ASSUMPTIONS

Billions of US Dollars

1) Imports Grow by 10% and Exports Show Zero Growth

	<u>Exports</u>	<u>Imports</u>	<u>Trade A/C</u>	<u>Current A/C*</u>	<u>Net Foreign Assets*</u>
1986	190	110	80	80	210
1987	190	121	69	74	284
1988	190	133	57	66	350
1989	190	146	44	56	406
1990	190	161	29	45	451

2) Imports Grow by 10% and Exports Contract 10% Every Year

	<u>Exports</u>	<u>Imports</u>	<u>Trade A/C</u>	<u>Current A/C*</u>	<u>Net Foreign Assets*</u>
1986	190	110	80	80	210
1987	171	121	50	54	264
1988	154	133	21	26	290
1989	139	146	-8	-3	287
1990	125	161	-36	-34	253

3) Imports Grow by 10% and Exports Contract 20% Every Year

	<u>Exports</u>	<u>Imports</u>	<u>Trade A/C</u>	<u>Current A/C*</u>	<u>Net Foreign Assets*</u>
1986	190	110	80	80	210
1987	152	121	31	33	243
1988	122	133	-12	-10	233
1989	97	146	-49	-51	182
1990	78	161	-83	-91	91

* The current account balance and net foreign assets are approximate estimates, based on the assumptions that Japan earns annual interest on its net foreign asset holdings at a rate of 7% and that the deficit on invisibles other than investment income remains at the level estimated for calendar 1986.

made clearer by the table on page 19, which shows the derived trade and current account balances underlying the three different projections for the net foreign assets given in Chart 4.

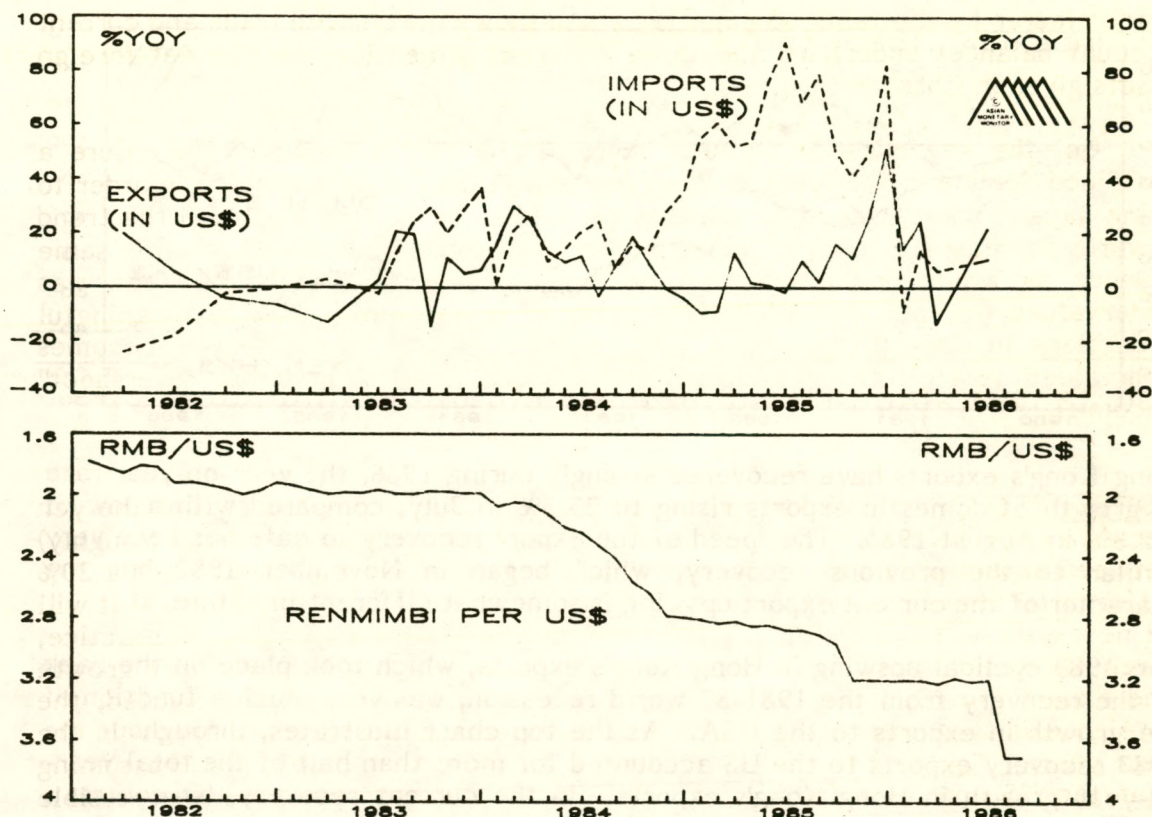
So, the key question is what level of the yen is necessary to ensure a sustained decline in the level of Japanese exports? This is necessary in order to bring Japan's current account position back towards balance and stem the trend towards increased growth in Japan's enormous net foreign assets. In the same manner as which Japan's current account surplus rose whilst the yen was undervalued (in the 1980-85 period) relative to estimated PPP so meaningful reductions in Japan's current account surplus require that the yen becomes overvalued relative to estimated PPP. How large might this "overshoot" become?

FORECAST: Over 1983-1985 an approximately 15% undervaluation of the yen versus its PPP level with the US dollar produced only a 10% differential (roughly) between export and import growth rates. Conversely, in order to produce a 20% differential between import growth and export growth (case 2 in Chart 4) it will be necessary to have anything up to 30% overvaluation of the yen. In practice, given the requirement for a large average differential between import growth and export growth to be maintained over the whole five years projected, the foreign exchange markets are likely to experience a greater 'overshoot' in the near years. Applying these principles to the PPP chart (Chart 3) and assuming that the US and Japan return to "equilibrium" by 1990 the following possible profile emerges for the yen/US dollar rate:

YEAR AVERAGE YEN/US DOLLAR RATE

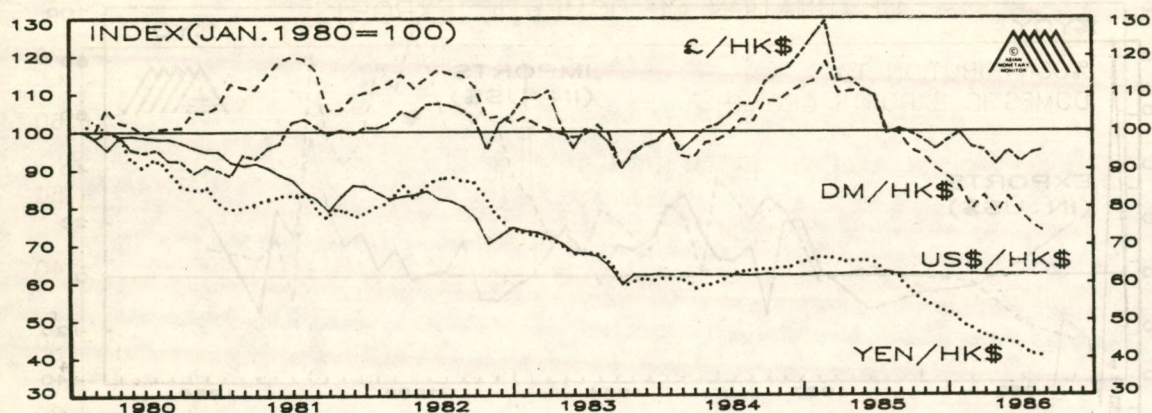
1986	US\$1 = Yen 160
1987	US\$1 = Yen 125
1988	US\$1 = Yen 110
1989	US\$1 = Yen 125
1990	US\$1 = Yen 130

PEOPLE'S REPUBLIC OF CHINA RENMINBI DEVALUATION IMPROVES EXPORT PROSPECTS



On July 5 the Renminbi yuan (RMB) was devalued by 13.6%, taking to 31% the Chinese currency's total depreciation against the US dollar since China's economic reforms were accelerated in October 1984, and 61% since mid-1980. The depreciation has been made necessary by China's burgeoning trade deficit, which reached a record US\$13.1 bn for all of 1985 and narrowed only slightly during the first half of 1986 - to US\$6.4 bn for the six months. In one sense, however, the trade deficit cannot be considered the ultimate cause of the RMB's depreciation as normally, in an economy enjoying a high rate of return to investment, a trade deficit would be financed at a stronger exchange rate by capital inflows. In China's case it is the constraints to capital inflows which have meant that the trade deficit has translated into a drain on foreign reserves.

Despite the extent of the RMB's decline it appears inevitable that, in the absence of a further significant increase in China's overseas borrowings, the Chinese currency will remain under downward pressure. Nevertheless, the weaker RMB should help narrow the trade deficit somewhat. At current levels of the RMB the effect of depreciation on imports must still be considered insignificant because the major determinant remains the allotment of foreign exchange quotas and other state controls - which have been significantly tightened this year. However, in the short-run the weaker currency - as well as other incentives introduced by the authorities - should have the effect of increasing exports through diverting goods to foreign markets which otherwise would have gone to satisfy domestic demand. Indeed, non-oil exports are already showing a significantly improved performance which has translated into a year-on-year rise in total exports of 14.3% for the first half, despite the oil price collapse, which has cost China roughly US\$2.8 bn annually in lost revenues.

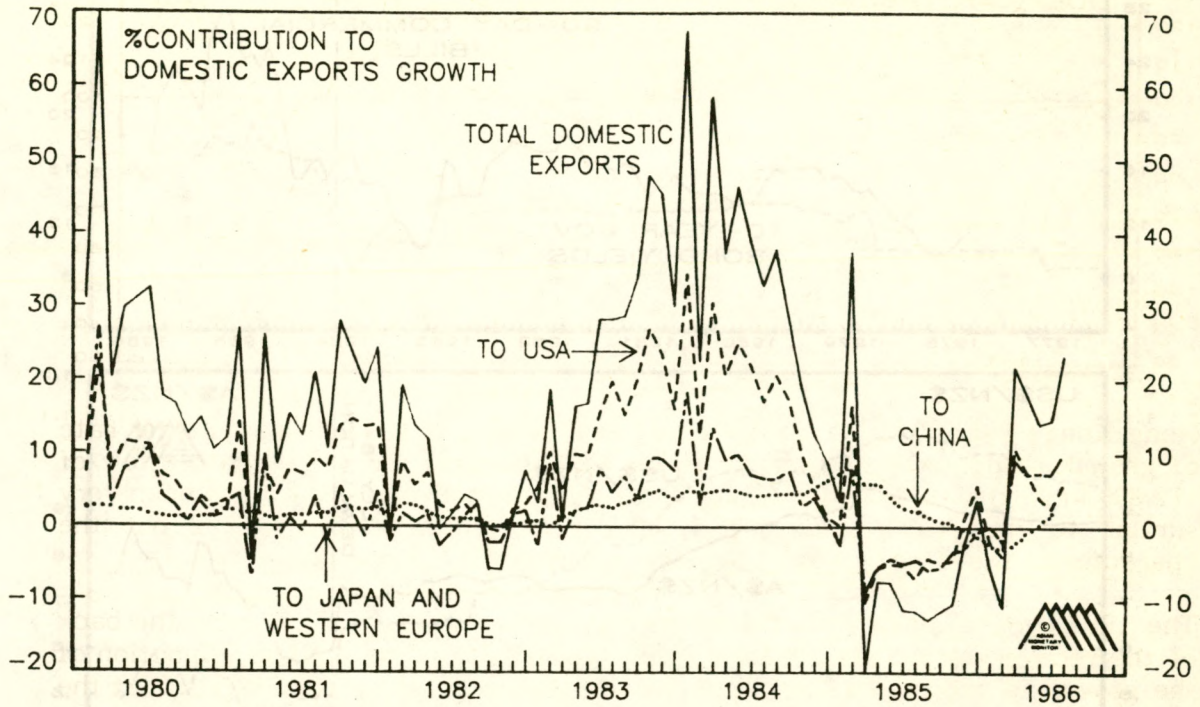


Hong Kong's exports have recovered strongly during 1986, the year-on-year rate of growth of domestic exports rising to 23.3% in July, compared with a low of -12.8% in August 1985. The speed of the export recovery to date has been very similar to the previous recovery, which began in November 1982 but the character of the current export upswing is somewhat different in nature.

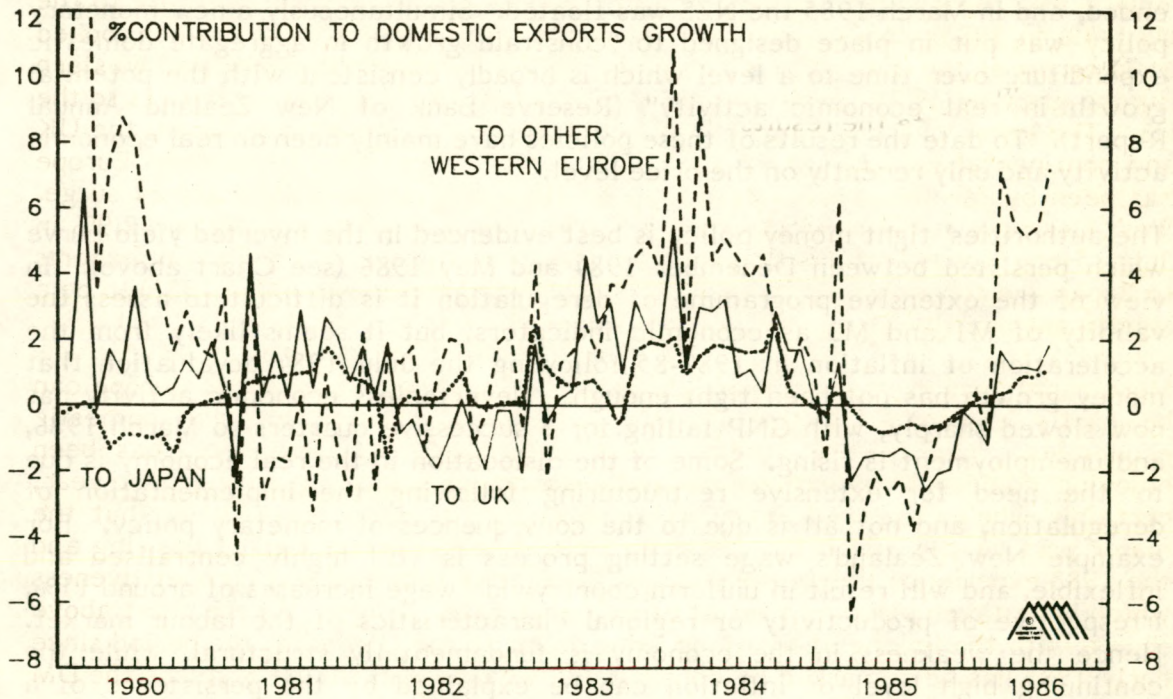
The 1983 cyclical upswing in Hong Kong's exports, which took place on the back of the recovery from the 1981-82 world recession, was very much a function of the growth in exports to the USA. As the top chart illustrates, throughout the 1983 recovery exports to the US accounted for more than half of the total year-on-year growth in Hong Kong's exports. In the current recovery, by contrast, exports to the US have been comparatively less important to growth than exports to Japan and Western Europe, when the latter countries are considered as a bloc. Exports to Japan and Western Europe contributed 10.2% to July's 23.3% year-on-year domestic export growth, whereas exports to the US contributed 'only' 6.0%. Because the largest part of Hong Kong's domestic exports are to the US (44% in 1985), this difference is necessarily even more marked when looked at in terms of the absolute growth rates. In July, exports to Japan and Western Europe grew by 39.7% year-on-year, compared to 13.3% growth in exports to the US. The lower chart separates "Japan and Western Europe" into Japan, the UK and continental Europe. From the chart it can be seen that continental Europe has been by far the most significant contributor to Hong Kong's export surge. West Germany is the most significant market, with exports growing by 42.9% in July. Hong Kong's exports to Japan are also growing rapidly (34.7%) but exports to Japan are too small a part of Hong Kong's total exports (3.4% in 1985) to be a significant contributor to overall export growth.

More rapid growth in Hong Kong's exports to Japan and continental Europe can be partly explained by the relative strength of their respective domestic economies. Continental Europe - and particularly W. Germany - has been enjoying comparatively strong domestic economic growth over the past year, certainly when compared with 1983. However, it seems more likely that the major part of the difference between Hong Kong's current export upswing and the 1983 experience lies in the changes in relative international competitiveness which have taken place as a result of exchange rate changes. As the chart above shows, with the linking of the Hong Kong dollar to the US dollar, the period since early 1985 has been marked by considerable weakness in the HK\$ versus the DM and yen, even as Hong Kong's inflation rate has fallen to a low 2%.

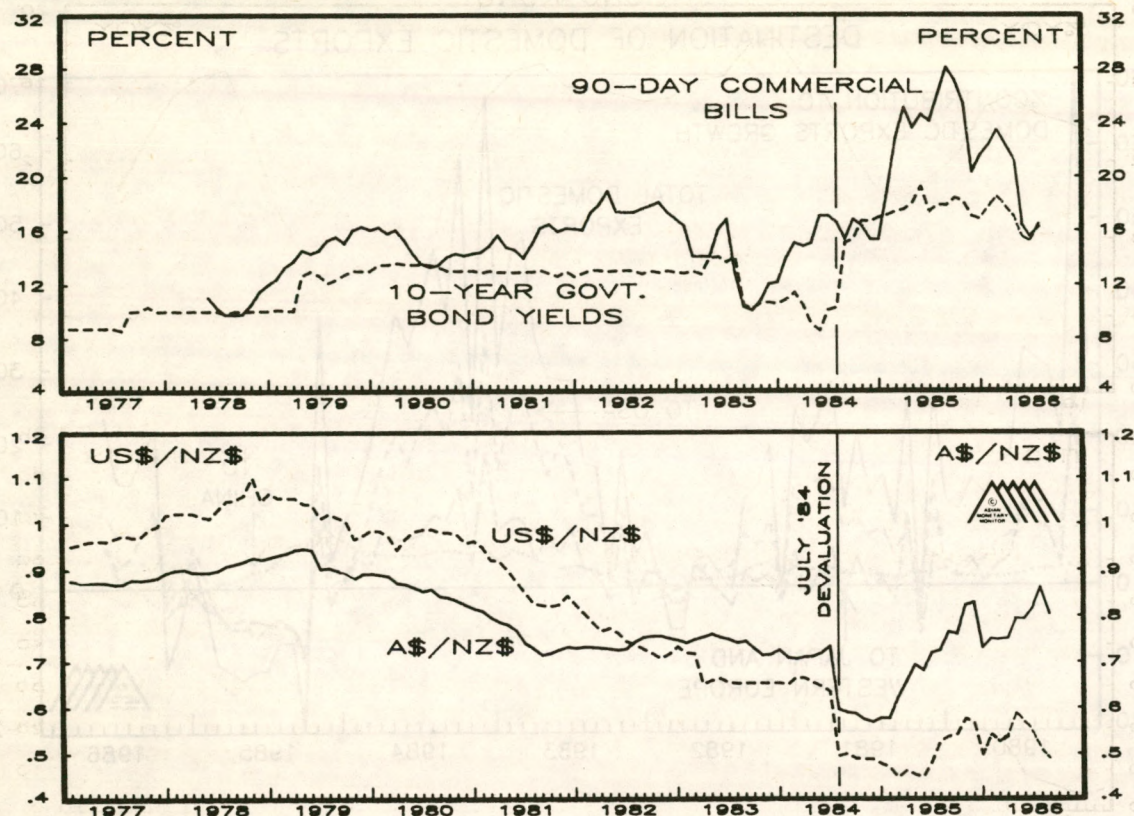
HONG KONG DESTINATION OF DOMESTIC EXPORTS



HONG KONG DOMESTIC EXPORTS TO EUROPE AND JAPAN



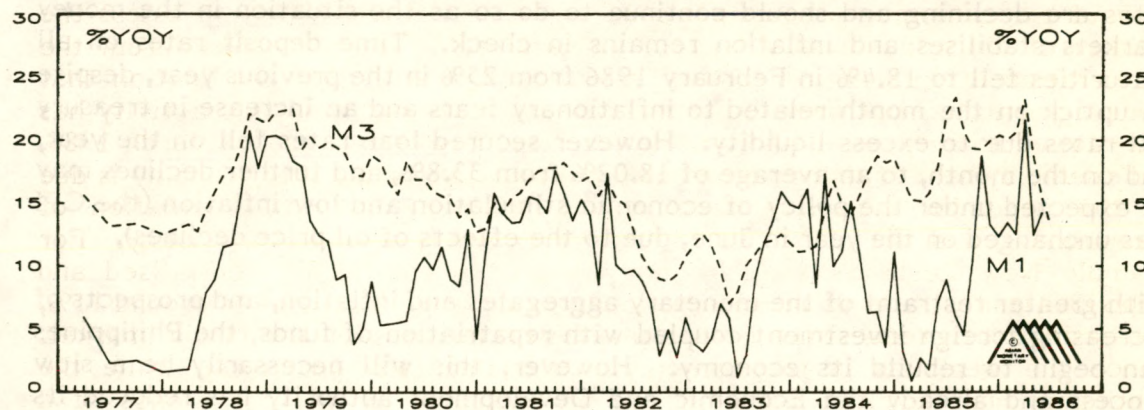
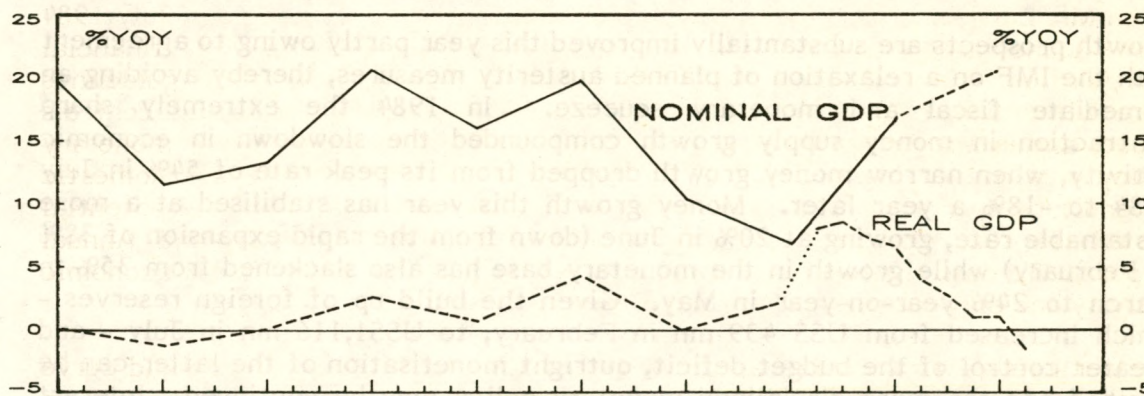
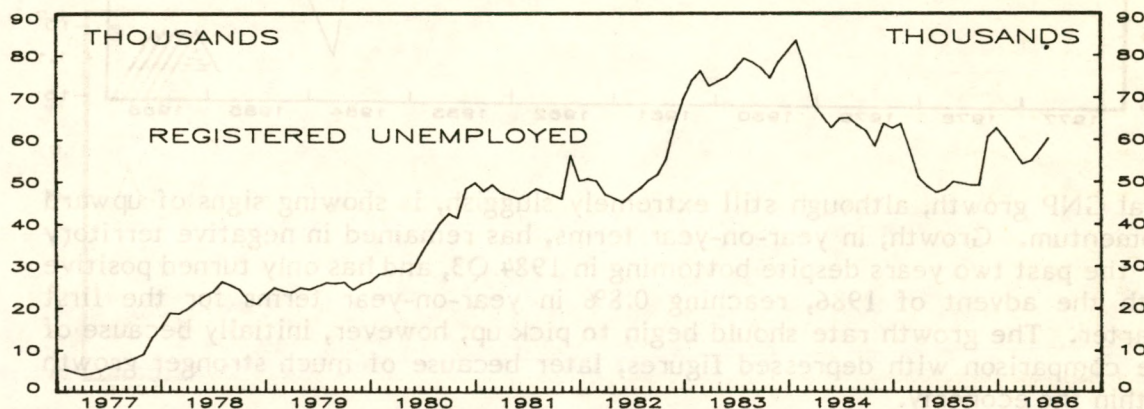
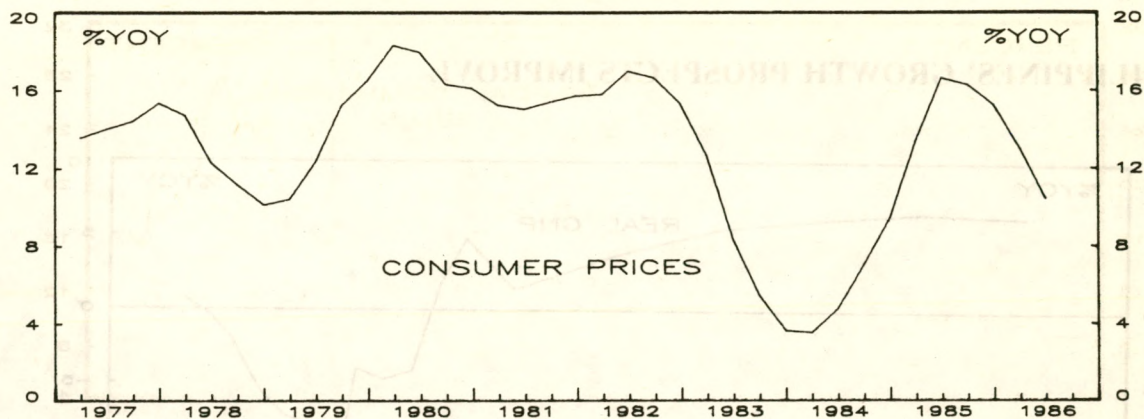
NEW ZEALAND ECONOMY SLOWS AS NEW POLICIES START TO TAKE EFFECT



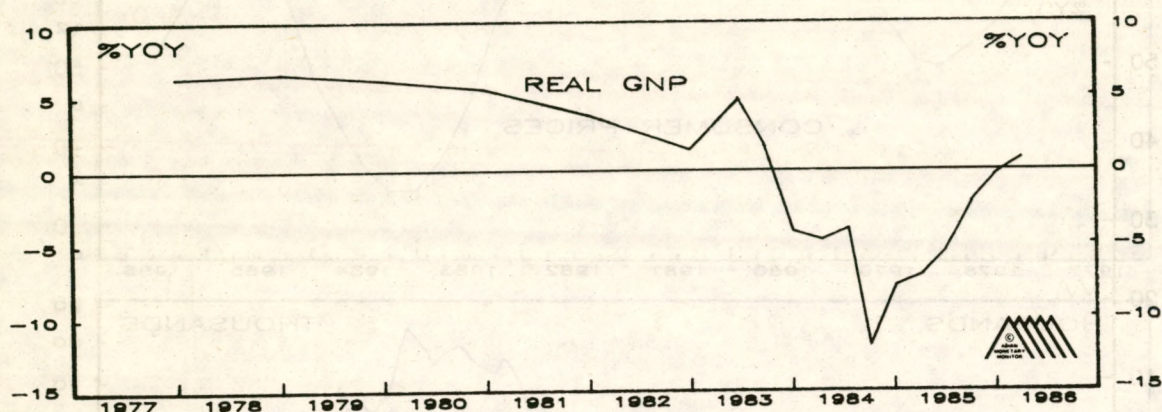
When Mr. Lange's labour government came to power in New Zealand in July 1984 they immediately started on a wide-ranging programme of financial deregulation. Controls on interest rates were abolished, bank credit guidelines were withdrawn, compulsory bank asset ratios were removed, exchange controls ended, and in March 1985 the NZ\$ was floated. Simultaneously a new monetary policy was put in place designed to "constrain growth in aggregate domestic expenditure over time to a level which is broadly consistent with the potential growth in real economic activity" (Reserve Bank of New Zealand Annual Report). To date the results of these policies have mainly been on real economic activity and only recently on the price level.

The authorities' tight money policy is best evidenced in the inverted yield curve which persisted between December 1984 and May 1986 (see Chart above). In view of the extensive programme of deregulation it is difficult to assess the validity of M1 and M3 as economic indicators, but it seems likely from the acceleration of inflation in 1984-85 following the July 1984 devaluation that money growth has not been tight enough. Nevertheless economic activity has now slowed sharply, with GNP falling for 3 successive quarters to March 1986, and unemployment is rising. Some of the dislocation in the real economy is due to the need for extensive restructuring following the implementation of deregulation, and not all is due to the consequences of monetary policy. For example New Zealand's wage setting process is still highly centralised and inflexible, and will result in uniform countrywide wage increases of around 11%, irrespective of productivity or regional characteristics of the labour market. Hence the weakness in the economy is fundamentally structural, while the continuing high level of inflation can be explained by the persistence of a monetary policy which has accommodated excessively high wage claims.

NEW ZEALAND MONEY, OUTPUT, EMPLOYMENT AND PRICES



PHILIPPINES' GROWTH PROSPECTS IMPROVE

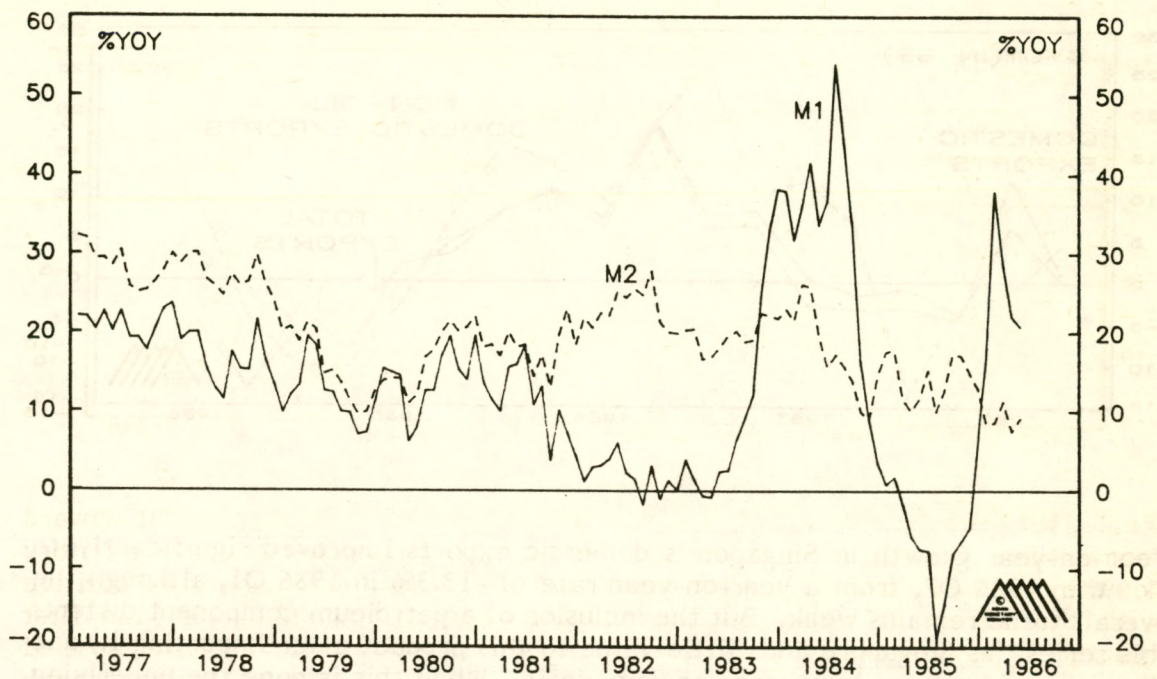


Real GNP growth, although still extremely sluggish, is showing signs of upward momentum. Growth, in year-on-year terms, has remained in negative territory for the past two years despite bottoming in 1984 Q3, and has only turned positive with the advent of 1986, reaching 0.8% in year-on-year terms for the first quarter. The growth rate should begin to pick up, however, initially because of the comparison with depressed figures, later because of much stronger growth within the economy.

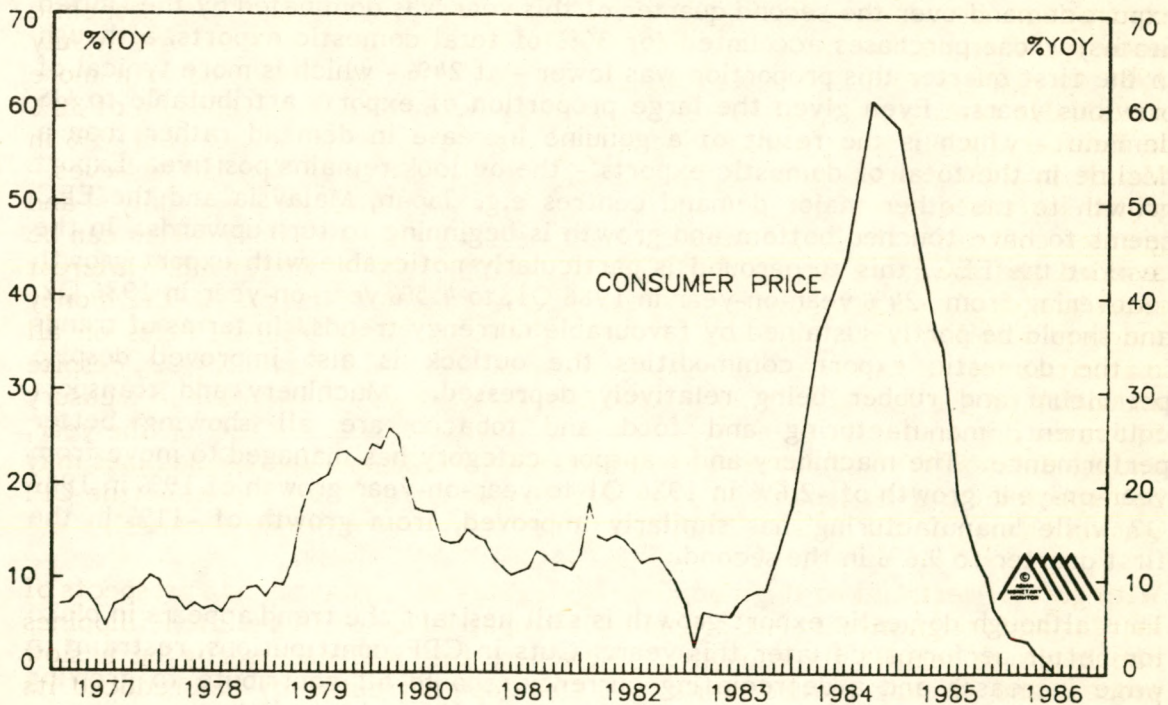
Growth prospects are substantially improved this year partly owing to agreement with the IMF on a relaxation of planned austerity measures, thereby avoiding an immediate fiscal and monetary squeeze. In 1984 the extremely sharp contraction in money supply growth compounded the slowdown in economic activity, when narrow money growth dropped from its peak rate of 54% in July 1984 to -18% a year later. Money growth this year has stabilised at a more sustainable rate, growing at 20% in June (down from the rapid expansion of 38% in February) while growth in the monetary base has also slackened from 35% in March to 24% year-on-year in May. Given the build up of foreign reserves - which increased from US\$ 439 mn in February, to US\$1,116 mn in July - and greater control of the budget deficit, outright monetisation of the latter can be avoided and the more disciplined monetary policy may be continued. Interest rates are declining and should continue to do so as the situation in the money markets stabilises and inflation remains in check. Time deposit rates on all maturities fell to 18.4% in February 1986 from 25% in the previous year, despite an uptick on the month related to inflationary fears and an increase in treasury bill rates due to excess liquidity. However secured loan rates fell on the year, and on the month, to an average of 18.02% from 33.8%, and further declines may be expected under the policy of economic stimulation and low inflation (the CPI was unchanged on the year in June, due to the effects of oil price declines).

With greater restraint of the monetary aggregates and inflation, and prospects of increasing foreign investment coupled with repatriation of funds, the Philippines can begin to rebuild its economy. However, this will necessarily be a slow process and already the Economic and Development authority has reduced its growth estimate to 0.9-1.0% for this year, although this should be achievable.

THE PHILIPPINES MONEY SUPPLY

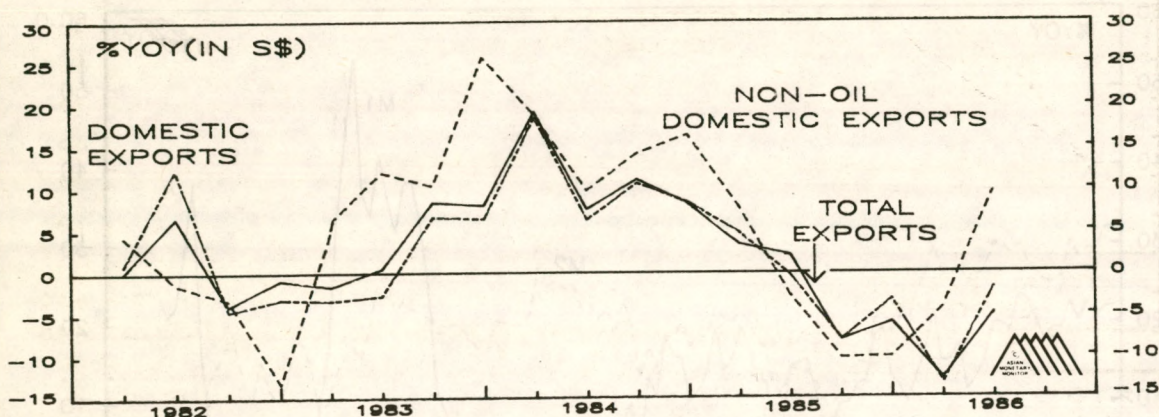


THE PHILIPPINES CONSUMER PRICES



SINGAPORE

A BETTER PERFORMANCE FROM DOMESTIC EXPORTS

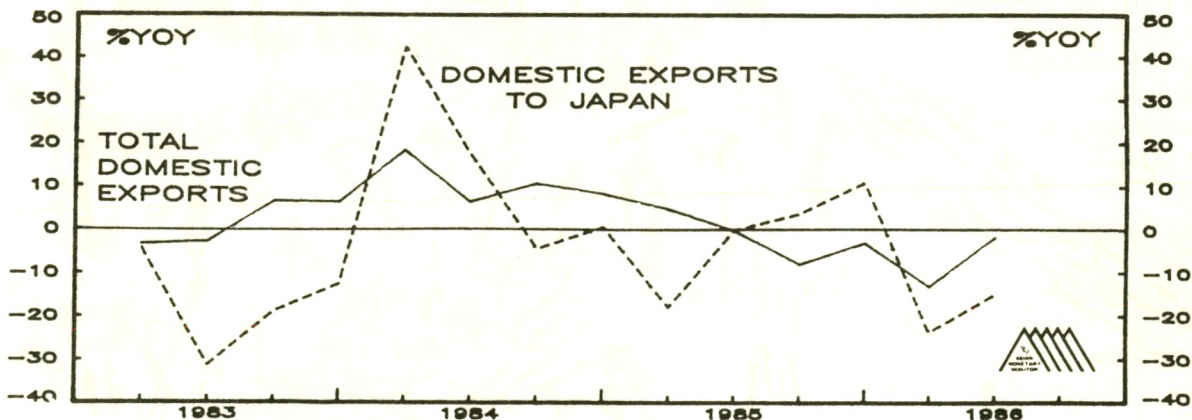
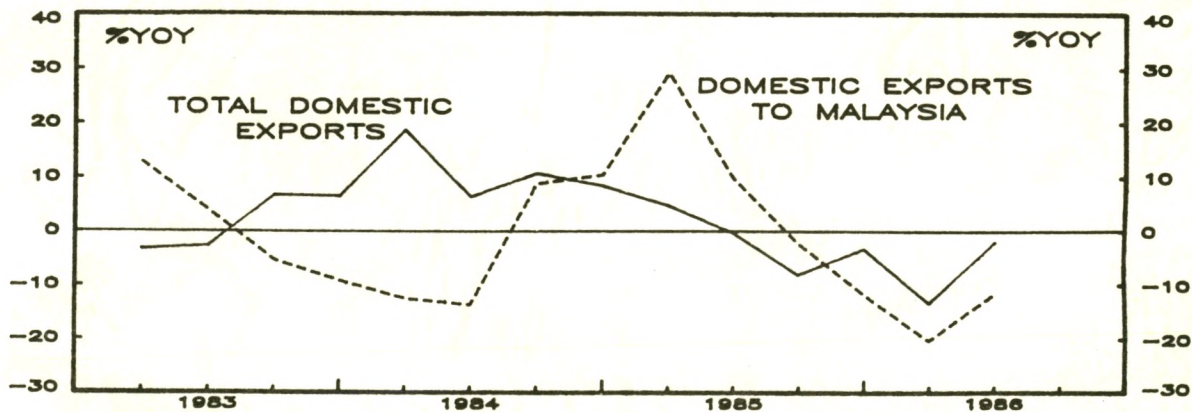
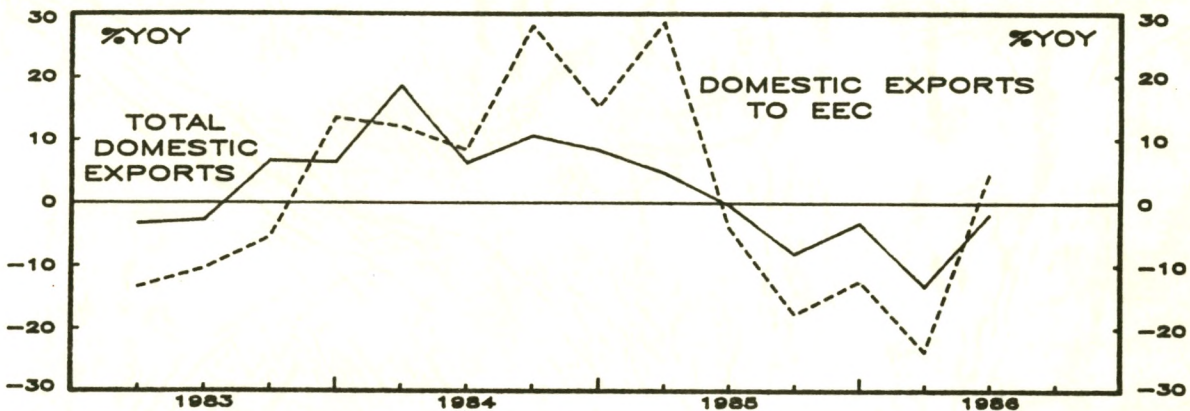
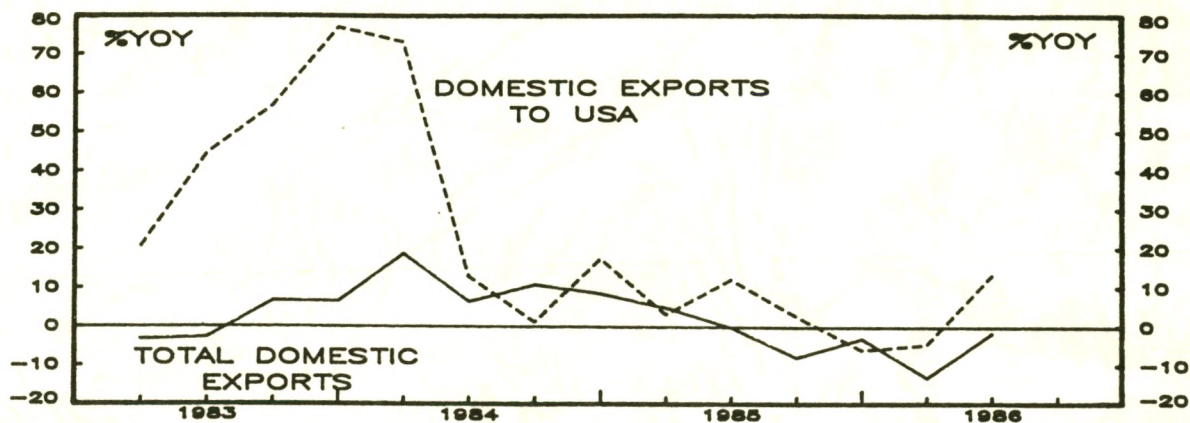


Year-on-year growth in Singapore's domestic exports improved significantly to -1.9% in 1986 Q2, from a year-on-year rate of -13.3% in 1986 Q1, although the overall trend remains weak. But the inclusion of a petroleum component distorts this series, (as Singapore adds little value to this product after importing it) and thus it would appear legitimate to remove it. When this is done the underlying trend is more positive - in 1986 Q1 non-oil domestic exports grew at a year-on-year rate of -4.3% while in 1986 Q2, growth picked up to 9.5% - which points to an improvement in the direction of overall export trends.

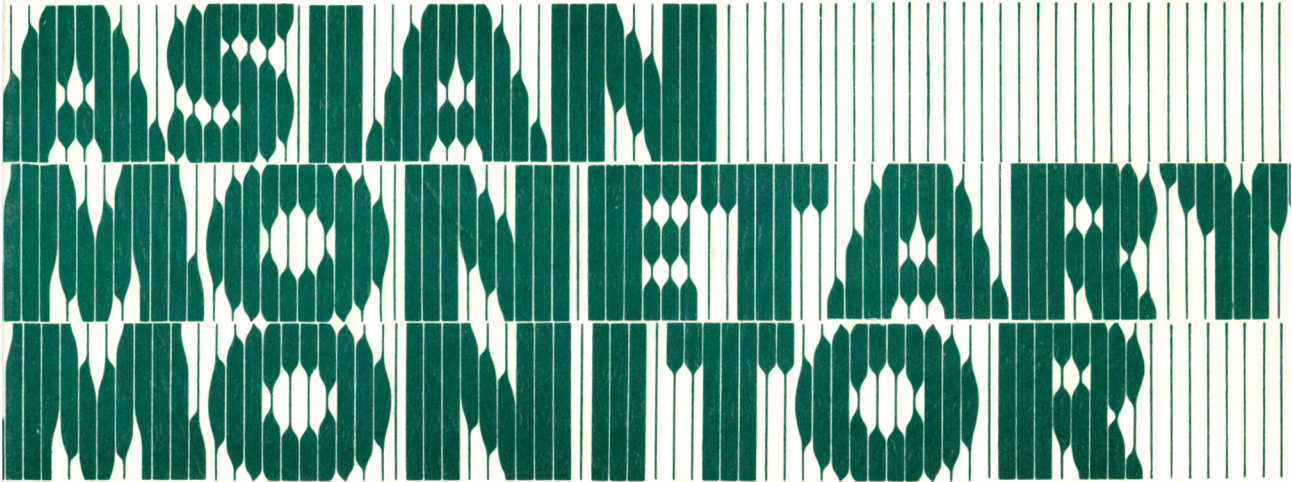
Although the recovery is still patchy it appears to be sustainable. Domestic export demand over the second quarter of this year was dominated by the United States, whose purchases accounted for 30% of total domestic exports, although in the first quarter this proportion was lower - at 24% - which is more typical of previous years. Even given the large proportion of exports attributable to US demand - which is the result of a genuine increase in demand rather than a decline in the total of domestic exports - the outlook remains positive. Export growth to the other major demand centres e.g. Japan, Malaysia and the EEC seems to have touched bottom and growth is beginning to turn upwards. In the case of the EEC, this turnaround is particularly noticeable with export growth recovering from -24% year-on-year in 1986 Q1, to 4.5% year-on-year in 1986 Q2, and should be partly sustained by favourable currency trends. In terms of trends in the domestic export commodities the outlook is also improved despite petroleum and rubber being relatively depressed. Machinery and transport equipment, manufacturing and food and tobacco are all showing better performance. The machinery and transport category has managed to move from year-on-year growth of -2.6% in 1986 Q1 to year-on-year growth of 19% in 1986 Q2 while 'manufacturing' has similarly improved, from growth of -11% in the first quarter to 9.6% in the second.

Thus although domestic export growth is still hesitant the trend appears in place for better performance later this year. Cuts in CPF contributions, restraint in wage increases and a depreciating currency, should all contribute to growing competitiveness of domestic firms in foreign and domestic markets.

SINGAPORE: GEOGRAPHICAL DISTRIBUTION IN DOMESTIC EXPORTS GROWTH







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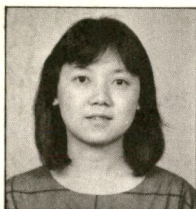
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KEYS TO SYMBOLS USED IN THE CHARTS

- | | |
|------|---|
| % RP | — Percentage Rate of change over Preceding period. |
| % RS | — Percentage Rate of change over Same period of preceding year. |
| SA | — Seasonally Adjusted. |
| SAAR | — Seasonally Adjusted at Annualised Rate. |

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HONG KONG: WHAT THE HONG KONG MARKET SAYS ABOUT 1997

I. Introduction

Hong Kong's transition from British to Chinese rule in 1997 has injected a high degree of uncertainty into the evaluation of asset prices. This has created an extremely complex but very interesting economic problem. On the one hand Chinese officials seem to be sincere about continuing the system under which Hong Kong has enjoyed rapid economic growth. One reason is that China gains a great deal from Hong Kong economically at present. The "four modernisations" will go forward much more rapidly if China has a nucleus of people with the business skills possessed in such abundance by Hong Kong. Hong Kong is also a large market for China's exports, purchasing about 30% of them in 1985. Also, China's treatment of Hong Kong will affect the way the Taiwanese respond to China's overtures for reunification.

If politics were dominated by economics, there would be no question that Hong Kong would have an extremely bright future. But, "The Great Leap Forward" and "The Great Proletarian Cultural Revolution" were unleashed by political leaders concerned with matters other than economic progress. Although China has been moving toward the use of the market since 1979, their past record has to make the prudent Hong Kong citizen and investor pause.

Therefore, a contrasting alternative is that, even with the best intentions, the Chinese, through ignorance, will adopt mistaken policies with respect to free trade, free prices, property rights, or the rule of law. These are four very abstract, fragile concepts which require far-sighted, disinterested and statesmanlike qualities from the political leaders if they are to remain in force. Another problem is that at some date in the future, Hong Kong may be a bargaining chip in a power struggle between opposing factions in China. In this case, Hong Kong's prosperity will be traded by one group for political gains in another area. On a more mundane level, the possibilities for corruption are numerous under a regime which does not uphold these four principles; if corruption becomes too widespread Hong Kong will inevitably suffer.

While the situation is very complicated, it does present interesting investment possibilities which we explore here. We first construct four different scenarios for Hong Kong's future and see what they imply about the value of property and equity shares. The reader can look on this exercise as either quantifying what the market expects to happen in 1997, or he can impose his own probabilities on the likely outcome and then decide whether assets are correctly valued or not. If assets are "mispriced", this is not due to any disequilibrium but

is necessary to cause a perfectly logical portfolio restructuring.

If Hong Kong's assets were priced at world levels, local residents would end up owning the bulk of them because their knowledge of local factors would give them an advantage over foreigners. However, prudence dictates that Hong Kong residents shift a substantial portion of their wealth out of the territory. Their collective action in trying to do so depresses Hong Kong asset prices enough to induce foreigners to buy them at prices which compensate for the risk of 1997 and the lack of foreign knowledge about Hong Kong. The foreign international portfolio investor will only put a small part of his wealth in Hong Kong so that if his investment turns sour he does not risk everything. But assets are priced attractively enough for him to be enticed to make some commitment. Thus, we see a two-way capital flow out of and into Hong Kong.

The next section outlines four different scenarios for the Hong Kong economy and their effect on property prices. We then investigate the equity market in order to quantify what stock market investors are saying about Hong Kong's future.

II. The Four Scenarios

Table 1 shows the assumptions we make about the expected percentage change in real rents in the following four cases.

Case A. China succeeds with the four modernisations and gradually becomes a 'capitalist' economy. Hong Kong prospers.

In this case, everything one could reasonably desire from China occurs. The Chinese continue liberalising their markets as they have done since 1979 and China's economy would continue its rapid development. Considering China's desperately low base today, real growth of 8% p.a. would be easily accomplished.

Hong Kong's future would also be secure since Hong Kong would be an enormous asset to China, and compatible politically. The Chinese will have a large group of people who know what precisely needs to be done for profitable investment. They speak the same language and have much cultural similarity. Politically, China would not change Hong Kong greatly. One country, two systems would be a transition with an eventual convergence into one country, one system - Hong Kong's.

The implications for the Hong Kong economy are obvious. Some newly-industrialised countries (NICs) worry about the sources for their next stage of economic development. Hong Kong's will come from providing goods and especially services to the huge Chinese market. It will be quite easy to maintain high rates of growth, and the only constraint will be the overall educational level of the population. Corporate profits and rents will rise through time.

The rental yield after expenses in Hong Kong is one of the highest in the world. It is currently 9%-10% on commercial buildings and 11%-12% on residential buildings. Chart 1 illustrates the cause of this yield for private domestic dwellings and offices. Since mid-1985 the simple average of the indices of rental values has risen by 11% while that of capital value has remained

HONG KONG: CHART 1

RENTAL AND CAPITAL VALUES FOR OFFICES AND DOMESTIC PREMISES

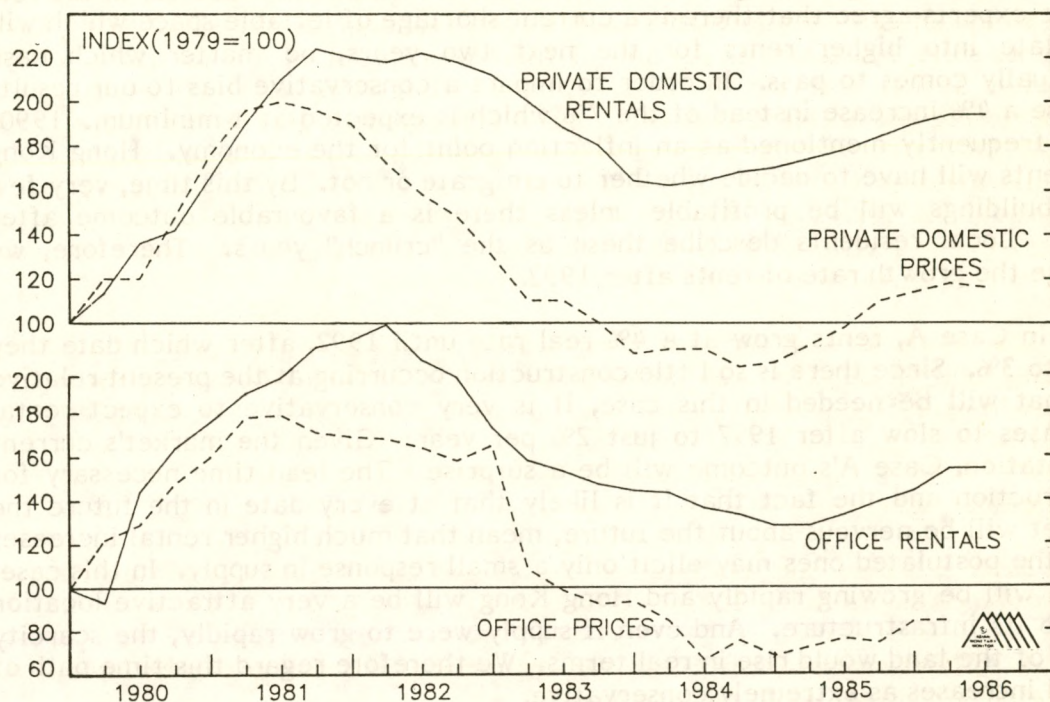


TABLE 1

DIFFERENT SCENARIOS AND THEIR EXPECTED REAL CHANGES IN RENT FOR THE HONG KONG PROPERTY MARKET

Years	CASE			
	A	B	C	D
1987-1988	4	4	4	4
1989	4	2	0	0
1990	4	2	0	-2
1991-1992	4	2	0	-4
1993-1997	3	1	-2	-8
1998-2006	3	1	-4	-16
2007	2	1	-4	-100
2008-2035	2	1	-4	0
2036	-100	-100	-100	0

roughly constant.

The first column of Table 1 shows the assumptions about different expected percentage changes in the real value of rents for Case A. Most real estate experts agree that there is a current shortage of lettable space which will translate into higher rents for the next two years, no matter which case eventually comes to pass. In order to impart a conservative bias to our results we use a 4% increase instead of the 7% which is expected at a minimum. 1990-92 is frequently mentioned as an inflection point for the economy. Hong Kong residents will have to decide whether to emigrate or not. By this time, very few new buildings will be profitable unless there is a favourable outcome after 1997. Local residents describe these as the "crunch" years. Therefore, we change the growth rate of rents after 1992.

In Case A, rents grow at a 4% real rate until 1992, after which date they slow to 3%. Since there is so little construction occurring at the present relative to what will be needed in this case, it is very conservative to expect rental increases to slow after 1997 to just 2% per year. Given the market's current expectation, Case A's outcome will be a surprise. The lead time necessary for construction and the fact that it is likely that at every date in the future the market will be nervous about the future, mean that much higher rental increases than the postulated ones may elicit only a small response in supply. In this case, China will be growing rapidly and Hong Kong will be a very attractive location due to its infrastructure. And even if supply were to grow rapidly, the scarcity value of the land would rise in real terms. We therefore regard this time path of rental increases as extremely conservative.

Case B. China partially implements the four modernisations but remains socialist. Hong Kong continues growing but with constant uncertainty about its future.

It is more likely that China and Hong Kong will muddle through the next twenty years. Thus, we have two intermediate versions between the extreme cases A and D. In Case B, China makes some mistakes during the transition. China does not embrace capitalism. There is a constant backsliding on liberalising economic measures. However, Hong Kong is allowed to live its own way and China does not tamper greatly with the current system. The overall tone of this case is that China does nothing to disrupt Hong Kong in a tangible sense, but there remains a lingering unease about a possible shock just waiting to happen.

In this case, investment slows but does not evaporate altogether. The economy continues to expand, but everyone remains nervous. Since China is growing in this case, the service sector will grow also. But GNP growth will not be able to maintain its former rates, because of the decline in investment which has already started to occur.

In Case B, the time path of rents drops to 2% growth until 1992 after which it falls to just 1% growth. It remains at 1% growth until 2036 when these buildings are all assumed to collapse. The same problem about expectations occurs here as in Case A. At every time in the future, investors are uncertain about the future and thus do not build. Thus, this path is also conservative since

Hong Kong continues to grow, although not at rates experienced in the past.

Case C. China struggles with the four modernisations. Change of power leads to a decrease in the momentum of the reform movement. China's growth is limited. Hong Kong suffers from constant uncertainty and accordingly economic growth slows.

This case is similar to Case B, the only difference being in the magnitude of the numbers. China's reforms slow but they are still making a good faith effort for Hong Kong's success. Capital and talent flight are worse than in B, and international firms hesitate to expand their operations. A certain amount of investment occurs, but only in those projects with short payback periods.

In Case C, rents rise initially at the 4% rate currently expected as a minimum. They remain constant through 1992, and subsequently start to fall. They decline at a 2% compound rate until 1997 after which they fall at a 4% compound rate.

Case D. China abandons the "four modernisations" and its recent reforms are reversed. Hong Kong stagnates and eventually property becomes worthless.

In this case, the pessimists are correct in their appraisal of China. The precise combination of events is not as important as the results and the date that the reversal occurs. Perhaps the "Gang of Four" or their spiritual heirs return to power. Perhaps the Chinese decide to adopt policies which cause both capital and talented people to flee. As Hong Kong stagnates, it will no longer be as valuable to China as before, and Hong Kong's special privileges will become untenable given China's internal politics.

As time passes, this will become clearer to the general public which will no longer invest in any assets with long payback periods. A slow disintegration of Hong Kong's economy rather than a collapse should be possible unless there is a banking panic. In the absence of an actual invasion by China before 1997, a complete destruction of all asset prices does not occur until after the takeover.

Unless handled carefully, a banking panic is possible since banks' collateral, e.g. mortgages on now worthless buildings, would evaporate. This could lead to runs on those banks deemed weakest. If the authorities did not respond correctly, the whole banking system might collapse. Therefore, at some point, it might make sense for the monetary authority simply to redeem all Hong Kong dollar banknotes for US dollars, and convert all Hong Kong dollar deposits and contractual obligations into US dollar obligations at the stroke of a pen. While losing the interest on the note issue, the authorities would at least eliminate the perceived currency risk. This would not alleviate the problems of any particular bank, but would serve to make transparent the ultimate source of the difficulties facing the banking sector.

In the absence of a banking panic, we would not expect GNP to decline during the run-up to 1997. Imports would slow, construction would fall to zero, and investment in machinery would collapse. But those workers formerly in investment-type activities have to eat. Hong Kong's flexibility would come into play and wages would fall by the amount necessary to clear the labour market,

by 30%-50% if needed. Since there would be a huge demand for foreign exchange to send abroad for safekeeping, employment in the export sector would grow by enough to employ the now much cheaper labour. Meanwhile, immovable asset prices would fall and with no new investment, the depreciation of buildings and machinery would effectively be shipped abroad through a large trade surplus.

The fourth column of Table 1 shows the assumptions about rent for this case. Rents rise at a 4% real rate for 1987-88. Then the decline in rents sets in as firms begin to relocate away from Hong Kong. Rents are first stable, then decline by 2%, then 4%. After the inflection point in 1992, rents fall at an 8% annual rate. They fall at a 16% rate after 1997 and the buildings are assumed to be worthless by 2007.

Results. The price of Hong Kong property is normally discussed relative to the rent currently being earned on it. Recent properties have changed hands at rental yields ranging from 9% to 12%. Property with the lower yields usually has something else of value attached - such as the ability for further development - so that yields at the low end of the range are usually understating the property's potential. We allow for a current pricing of from 9% to 12% on an after-cost yield basis.

Table 2 shows the present value of future rents relative to today's prices for different discount rates, given the four scenarios about China, and original purchase yields. It is based on a current price of 100 for today's property. The index number in the table shows what the property would be worth relative to today's price if the market perceived the given assumptions to be true. Obviously, the choice of a discount rate can substantially affect whether purchasing property is wise or not. For our choices, we start with the fact that banks currently charge large borrowers an adjustable rate of less than 8% for loans with property as collateral. With annual expected inflation of about 3%, the borrower is paying roughly a 5% real interest rate. This seems reasonably in line with an average real rate of 3% for long-term US Treasury securities over the last 60 years. In this exercise, we use real discount rates of 5%, 6% and 7%.

The combination of these assumptions about discount rates, about the political future, and about the current price of property relative to its yield, generates 48 different possibilities for the ex post payoff from an investment in property. In only 9 of these cases is the present value of the future rents less than the current cost of buying a building. And, these nine cases only occur in the worst scenario. In the absolute worst, case the investor would lose 27% of the original value of the building. To show how bad things have to be in Hong Kong to achieve this result, note that the worst case assumes that property will be expropriated in 2007 and that rents will fall at an accelerating rate up to that date. By 1997, rents are expected to be at 64% of their current level and by 2000 at only 38% of their current levels. Notice also, that if property is purchased at an 11% or 12% yield, which is the price large properties have traded at recently, the purchaser only loses money if his discount rate for property is 7% real or greater.

In all of the other cases, Hong Kong property is currently extremely underpriced relative to its rental earnings. In fact, in the best of cases property would have to nearly quadruple in price for it to be priced at world levels.

TABLE 2

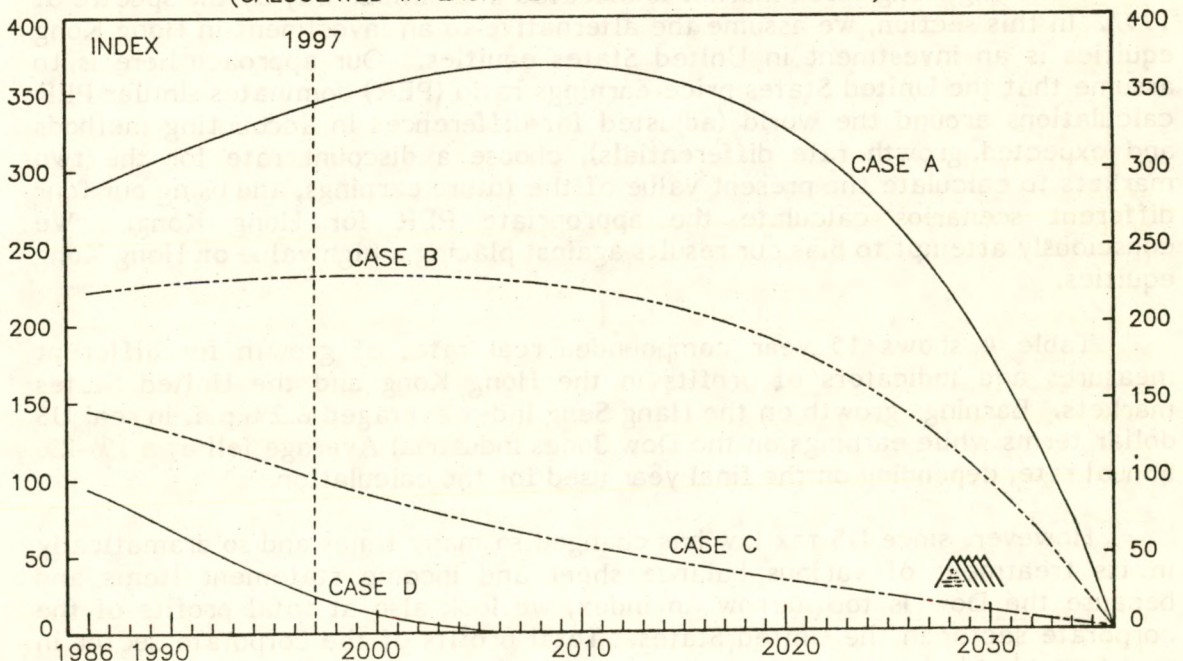
**PRESENT VALUE OF FUTURE RENTS RELATIVE TO CURRENT PRICES
WITH DIFFERENT SCENARIOS, DISCOUNT RATES
AND ORIGINAL PURCHASE PRICES**

Current Price = 100

Discount Rate	Original Purchase Price (Yield Basis)	CASE			
		A	B	C	D
5%	9% Yield	284	213	132	82
	10% Yield	315	237	147	91
	11% Yield	347	261	161	100
	12% Yield	378	284	176	109
6%	9% Yield	236	181	118	77
	10% Yield	262	201	132	86
	11% Yield	288	221	145	94
	12% Yield	314	242	158	103
7%	9% Yield	199	156	107	73
	10% Yield	221	174	119	81
	11% Yield	243	191	131	89
	12% Yield	265	208	143	97

HONG KONG: CHART 2

**PRESENT VALUE OF FUTURE RENTS
(CALCULATED IN EACH YEAR AS SEEN IN THAT YEAR)**



RENTS FOLLOW ASSUMED PATH. 6% DISCOUNT RATE. BUILDINGS AND LAND WORTHLESS IN 2036.
BASE=100 FOR BUILDINGS WHICH CAN BE PURCHASED TODAY AT AN 11% YIELD.

(Remember that Case A probably understates the time path of Hong Kong's rents.)

Chart 2 shows the time path of the present value of a building's future rent for the different cases. The present value is the discounted value of the future stream of rents computed back to the given year. A 6% real discount rate is used to compute the present value, and all values are expressed relative to a building which can be purchased in 1986 at an 11% yield after expenses. To impart a conservative bias, all land and buildings are assumed to have zero value in 2036 in all four cases. Note that for the worst case the present value of future rents from a building falls to just 24% of the base year price. That is, if Case D comes to pass and the market expects the time path of prices postulated, then a building will be worth only 25% of its current value in 1997. We regard this as conservative even for this worst of cases.

Table 3 shows a different approach to the same problem. In this table, we assume that rents grow at a 4% real rate for 1987 and 1988 but then remain stable until the property is expropriated. This table shows at what date the market is assuming the property has a zero value under the 12 different assumptions about rental yields. It also assumes rents stay constant (i.e. they do not accord with the four scenarios outlined earlier). Then, depending on the assumptions, an investor will own the property free and clear by about 1998.

In conclusion, either property is tremendously underpriced or the market expects the worst from 1997. Another way to say the same thing is to say that the market has fully discounted the worst that could happen to properties, and thus any surprise which occurs will be a pleasant one.

III. The Equity Market

The Hong Kong stock market is affected in a similar way by the spectre of 1997. In this section, we assume the alternative to an investment in Hong Kong equities is an investment in United States equities. Our approach here is to assume that the United States price-earnings ratio (PER) dominates similar PER calculations around the world (adjusted for differences in accounting methods and expected growth rate differentials), choose a discount rate for the two markets to calculate the present value of the future earnings, and using our four different scenarios calculate the appropriate PER for Hong Kong. We consciously attempt to bias our results against placing a high value on Hong Kong equities.

Table 4 shows 15 year compounded real rates of growth for different measures and indicators of profits in the Hong Kong and the United States markets. Earnings growth on the Hang Seng Index averaged 6.2% p.a. in real US dollar terms while earnings on the Dow Jones Industrial Average fell at a 1%-2% annual rate, depending on the final year used for the calculation.

However, since US tax law has changed so many times and so dramatically in its treatment of various balance sheet and income statement items and because the Dow is too narrow an index, we look also at total profits of the corporate sector in the United States. Total profits of the corporate sector in real terms but before any other adjustments grew at a 0.9% annual rate over the

TABLE 3
EXPECTED EXPROPRIATION DATES

Rental Yield	Real Discount Rate		
	5%	6%	7%
9%	2002	2004	2006
10%	2000	2001	2003
11%	1998	1999	2000
12%	1997	1998	1999

TABLE 4
FIFTEEN YEAR COMPOUND REAL RATES OF GROWTH IN US DOLLARS
FOR DIFFERENT PROFIT INDICES AND CONCEPTS
OF EARNINGS IN THE UNITED STATES AND HONG KONG

	Fifteen Years Ended		
	1985	1986 (Est.)	1987 (Est.)
Earnings of Hang Seng Index	6.1	6.2	6.2
Earnings of Dow Jones Industrial Average	-2.5	-1.3	-0.8
Hong Kong Profits Tax Collections from Corporations	12.6	NA	NA
Hong Kong Profits Tax Collections from Unincorporated Businesses	10.1	NA	NA
Real Profits of US Corporations	0.9	0.1	NA
Real Profits of US Corporations with Inventory Valuation Adjustment and Capital Consumption Allowance	3.6	2.7	NA
Real US Cash Flow	3.9	3.1	NA

15 year period which ended in 1985. After an inventory valuation adjustment (IVA) and capital consumption adjustment (CCAJ), which adjust for the effects of inflation on inventory and depreciation charges, total corporate profits in the United States grew at an average 3.6% through the end of 1985. We estimate they will average 2.7% growth through the end of 1986. US corporate cash flow, which adds back depreciation, grew at a 3.9% annualised rate through 1985.

Turning to broader measures of Hong Kong's profits, tax payments by corporations grew in real terms in US dollars at an annualised rate of 12.6% over the same fifteen years. The same figure for unincorporated firms is 10.1%. Since the tax rate paid by Hong Kong corporations increased from 16.5% to 18.5% during the period in question, this slightly overstates the relative health of Hong Kong companies. However, since tax collections grew appreciably faster than earnings on the Hang Seng Index, we can impart a conservative bias to our calculations by using the lower figure for Hong Kong and the higher figure for the United States when comparing growth across the two countries.

Table 5 shows the different assumptions about earnings growth in Hong Kong under the four different scenarios. First, analysts are projecting 20% real growth in earnings for next year and further growth in 1988. We apply this to all four scenarios. In the best case scenario, earnings grow at a 7% compounded rate until ten years after the takeover, after which they grow at a 5% real rate. This is quite conservative since if China really does grow rapidly, Hong Kong firms will be well-positioned to benefit, and yet we assume that the rate of increase in earnings will actually slow from what it has been recently.

In Case B, earnings grow initially at a 6% rate, slow to 5% until after the "crunch" years and then grow at 3% annually, which is roughly the rate of earnings growth after adjustments in the United States. In Case C, earnings growth drops to 3% until 1992, then down to 2% until 1997, after which point earnings stagnate. In Case D, earnings drop more rapidly still, with stagnation starting in 1993. After 1993 earnings fall at 2% for the first 5 years and then at a 5% compound rate forever after that.

Export firms will have much higher profits while property firms will disappear. Eventually, however, the export firms will also disappear. If export firms are under-represented on the stock market, while property firms are over-represented, earnings of publicly traded firms may fall during the transition.

The choice of a real discount rate for Hong Kong corporate earnings is our next step. The linkage of the exchange rate with the US dollar eliminates a potential source of confusion over rates. (While the choice of an exchange rate regime will in the long run have no effect on real interest rates provided there are no exchange controls, it may affect the perception of short run rates.)

First, we must investigate the risk characteristics of Hong Kong. The linkage of the exchange rate may have affected the systematic risk characteristics of investing in the Hong Kong stock market. We will not be certain this is so until after a few complete business cycles under the new regime, however. Table 6 shows the beta (which is the measure of risk added to a portfolio by a particular stock) for the Hong Kong stock market relative to the United States for different time periods. We see that Hong Kong's beta is

TABLE 5

ASSUMPTIONS ABOUT REAL PROFIT GROWTH IN HONG KONG

Year	CASE			
	A	B	C	D
1987	20	20	20	20
1988	7	6	6	6
1989	7	6	6	3
1990	7	6	3	3
1991-1993	7	5	3	1
1994-1997	7	3	2	0
1998-2002	7	3	0	-2
2003-2006	7	3	0	-5
2007-2186	5	3	0	-5

TABLE 6

BETA FOR THE HONG KONG STOCK MARKET
(t-statistic in parenthesis)

Time Period	Length of Return	
	Monthly	Quarterly
Total		
Mar 73-Sep 86	0.82 (4.33)	1.11 (5.61)
Pre-fix		
Mar 73-Sep 83	0.91 (4.20)	1.71 (7.65)
Post-fix		
Dec 83-Sep 86	0.33 (1.03)	0.38 (1.17)

Note: Beta estimated from the following equation:

$$HK = \alpha + \beta US \quad \text{where}$$

- (a) HK is the rate of return of the Morgan Stanley Capital International dividend reinvested index of Hong Kong stocks.
- (b) US is the rate of return of the Morgan Stanley Capital International dividend reinvested index of US stocks.
- (c) β is the regression coefficient, also known as the measure of systematic risk.

statistically significant for both monthly and quarterly returns when we use the entire period of our sample. However, the subsample after the fixing of the exchange rate has an insignificant beta. This seems sensible for two reasons. First, the previous exchange rate regime amplified the magnitude of the world business cycle's effect on Hong Kong. This would have caused the beta with respect to the United States to be higher and significant. Second, as 1997 approaches, the amount of variation in the local stock market attributable to world economic cycles as opposed to local concerns over the transition will decline. This should also reduce the beta.

We predict that with the maintenance of the linked rate and the increase in concerns over 1997, the Hong Kong stock market will continue to have a low beta. Thus, Hong Kong's risk is diversifiable. Classic analysis of the variance of a portfolio of securities stresses the importance of covariances in adding to overall variability (risk). In fact, in the limiting case of an infinite number of stocks, the variance of an individual stock is irrelevant to portfolio variability, only its covariances with other stocks (which beta measures) add to overall variability. If Hong Kong has low covariance with the US, it means that Hong Kong is not especially "risky" in a portfolio sense even though Hong Kong by itself may be. This means that adding Hong Kong to an international portfolio does not increase that portfolio overall variability, but probably decreases it over certain ranges. This is important because it means we can use a low discount rate to calculate the present value of Hong Kong's future earnings.

We use two approaches to choosing a discount rate and see that they yield roughly similar numbers. First, the US PER for the S&P 500 index was recently at 14.8. The inverse of this is a 6.75% rate. If the growth in real earnings is expected to be 2%-3% then the market is applying a 8.75% to 9.75% rate of discount to future earnings. The lower is expected growth of corporate earnings the lower is the market's discount rate. Second, US Treasury bonds are yielding 8.5% nominally. With an expected inflation rate of 3% bonds are yielding 5.5% in real terms. This is above the 3% which they averaged over the 60 years before the 1980s. With a 2%-3% differential for the greater risk in equities than in bonds we have arrived at a 7.5%-8.5% real discount rate for equities in the United States. Higher expected inflation rates imply that the market is discounting corporate earnings at a lower real rate.

Table 7 gives the different PER's for the four cases using four different real discount rates. If China moves forward as in Case A, and earnings follow the path given in Table 5 then clearly Hong Kong is extremely cheap relative to its eventual value. Even in the worst case, Case D, Hong Kong, with a PER of 16.6 as of this writing, is not extremely overpriced. In fact, if over time interest rates come down to their previous long-term averages of 3% real with a 2%-3% risk differential for equities yielding a 6% discount rate for stocks, Hong Kong is fairly priced even at a PER of 17 in Case D. The last column of Table 7 gives a weighted average of the PERs with the weights being the probability of the given case occurring (from the first row). Using this approach (which means that the reader agrees with our subjective probability distribution) we see that a 10% real discount rate is necessary to validate current levels of the market. If the correct rate is lower, as we think it is, then the market is still underpriced given the probable range of outcomes after 1997.

IV. Conclusion

1997 has given pause to the Hong Kong investor. A logical rebalancing of portfolios is currently occurring with Hong Kong residents selling at prices which are attractive to foreign investors. Our approach has been to either ask what the market is predicting about 1997, or else to identify mispricing of assets given certain assumptions about the probable time path of various prices. It appears the market is expecting the worst which is therefore enticing to the person at the margin, the foreign investor.

Given that the risk posed by the transfer of sovereignty in 1997 is diversifiable and that the PER is low in a probabilistic sense, international portfolio investors should have some fraction of their wealth in Hong Kong equities. The property market is even more depressed. This is probably because the greater liquidity of the stock market gives investors the illusion that if something begins to go awry they will be able to unload their stocks before anyone else. This obviously cannot be true for the market as a whole. For the property market, most investors realise that if the future starts to look unfavourable, then they will not be able to find a buyer for their property at any price.

TABLE 7

CALCULATION OF THE HANG SENG PRICE EARNINGS RATIO (PER) UNDER DIFFERENT ASSUMPTIONS

	A	CASE B	C	D	
Probability of Case Occurring	0.10	0.30	0.40	0.20	
Discount Rate	Calculated PER's				Weighted Average
10%	28.7	18.4	14.5	11.9	16.6
9%	36.6	21.6	16.3	13.0	19.3
8%	49.8	26.1	18.5	14.3	23.1
7%	75.1	32.8	21.4	15.8	29.1
6%	134.0	43.9	25.2	17.7	40.2

Current Historical PER = 16.6 (Historical earnings as of Nov. 14, 1986)

Current Prospective PER = 12.8 (Estimated earnings as of Nov. 14, 1986)

The export sector will be the least affected by a negative outcome since the demand for foreign exchange will increase dramatically for purposes of capital flight. The property sector will be the most affected by a positive outcome. Even if rents remain high in the run-up to 1997, construction will probably fall merely because of uncertainty. A defensive posture would be to own export-oriented stocks while a leveraged play on 1997 would be to own real estate.

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9%	36.6	21.6	16.3	13.0	19.3
8%	49.8	26.1	18.7	14.3	23.1
7%	72.1	32.8	21.4	15.8	29.1
6%	134.0	43.9	25.2	17.7	40.5

Current Historical PER = 16.3 (Historical earnings as of Nov. 14, 1986)

Current Prospective PER = 15.8 (Estimated earnings as of Nov. 14, 1986)

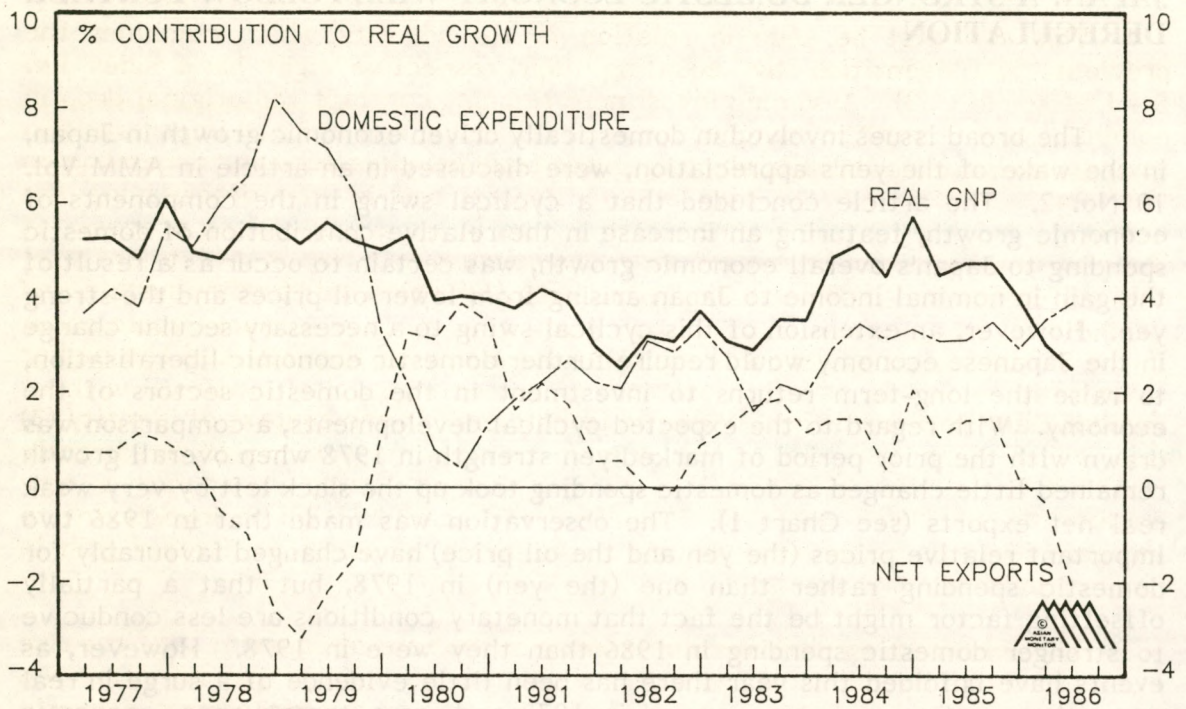
JAPAN: A STRONGER DOMESTIC ECONOMY WILL FOLLOW FURTHER DEREGULATION

The broad issues involved in domestically driven economic growth in Japan, in the wake of the yen's appreciation, were discussed in an article in AMM Vol. 10 No. 2. The article concluded that a cyclical swing in the components of economic growth, featuring an increase in the relative contribution of domestic spending to Japan's overall economic growth, was certain to occur as a result of the gain in nominal income to Japan arising from lower oil prices and the strong yen. However, an extension of this cyclical swing to a necessary secular change in the Japanese economy would require further domestic economic liberalisation, to raise the long-term returns to investment in the domestic sectors of the economy. With regard to the expected cyclical developments, a comparison was drawn with the prior period of marked yen strength in 1978 when overall growth remained little changed as domestic spending took up the slack left by very weak real net exports (see Chart 1). The observation was made that in 1986 two important relative prices (the yen and the oil price) have changed favourably for domestic spending rather than one (the yen) in 1978, but that a partially offsetting factor might be the fact that monetary conditions are less conducive to stronger domestic spending in 1986 than they were in 1978. However, as events have unfolded this year there has been little evidence of a surge in real domestic spending such as occurred in 1978 and, as a consequence, economic growth has fallen sharply as real net exports have slumped (see Chart 1). In the light of these developments, this article explores the differences between Japan's current economic experience and that of 1978, focusing on the relationship between financial deregulation and monetary conditions, and very briefly touches on further policy/legislative changes which the authorities are likely to take to encourage stronger domestic economic growth.

The previous article made use of the Keynesian income/expenditure framework, which as a starting point is a useful framework within which to analyse the cyclical effects of a 'one-off' gain in national income, such as Japan has enjoyed as a result of the strong yen and weak oil prices. If, for ease of exposition, we assume away the government sector, the two key Keynesian identities can be stated as $Y \equiv C + I + X - M$ (1) where Y = the GNP, or national income, C = consumption, I = investment, X = exports and M = imports, and $Y \equiv C + S$ (2), where S is savings. In nominal terms, the income gain occurs as imports, M in the first identity, fall in yen terms because of cheaper oil and the strong yen. The final cyclical effect on real income growth, however, depends upon the extent to which this income gain is spent on consumption or is saved i.e. the marginal propensity to save (or consume). If, from the second identity (on a 'best case' scenario), the nominal income gain is all spent on domestic product then a second round rise in income will occur (from (1)) equal in magnitude to the first, generating a second round rise in consumption spending, and so on ad infinitum. If, more likely, part of the nominal income gain is either saved or spent on imports, then further rises in income will occur roughly until savings and imports have increased to the extent of the original income gain, the final cyclical increase in real income and output then depending upon the propensity to save out of income and the propensity to import. In nominal terms the

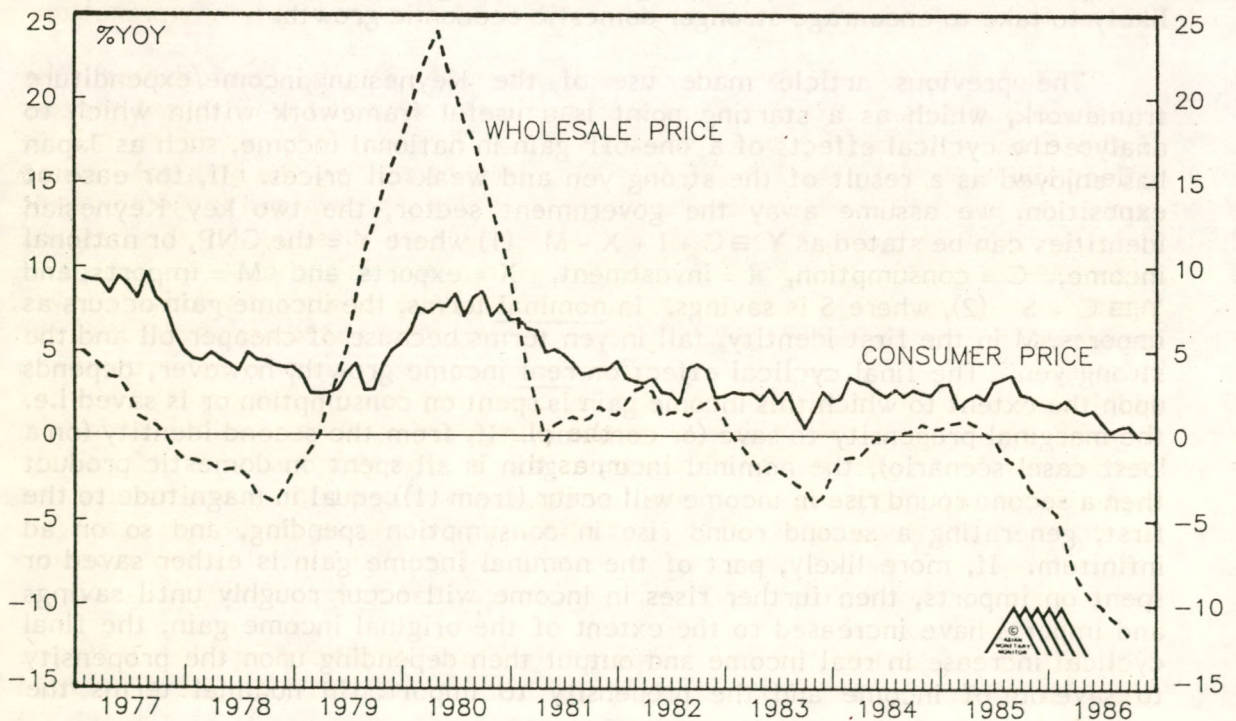
JAPAN

CHART 1: THE COMPONENTS OF ECONOMIC GROWTH



JAPAN

CHART 2: WHOLESALE AND CONSUMER PRICE INFLATION



increased savings then provide the capital outflow which finances the expanded trade surplus.

This can best be seen in relation to the identity which combines the previous two identities by equating their respective right hand sides i.e. $S - I \equiv X - M$ (3). Assuming investment remains constant the original drop in nominal imports must be matched by some offsetting rise in (real) imports and in savings, the process through which ultimate equilibrium is achieved depending on the marginal propensity to save and to import, and in turn determining the extent of the rise in real income which occurs in the equilibrating process. If the rise in savings and/or income somehow stimulates a rise in investment then this will generate further income gains (from (1)) which will further sustain and extend economic growth. On the other hand, a 'worst case' scenario would occur if the original income gain was all saved (or spent on imports) and the higher savings were directly invested overseas (representing capital outflows) without involving any increase in real domestic investment. In the context of identity (3) this would mean that the initial drop in nominal imports would be directly matched by a rise in savings which would immediately constitute a new equilibrium i.e. there would be no tendency for consumption or investment to increase (despite higher savings) and hence there would be no further gain in nominal income.

The fact that, as indicated in Chart 1, in the case of Japan in 1986 the rise in real domestic spending has been very limited in the wake of the rise in the yen and fall in oil prices, suggests that something closer to this 'worst case' scenario has emerged. Seeing the problem of disappointing domestic spending in this light focuses the issue on two central points. First, the propensity to save out of the terms of trade income gain Japan has enjoyed must have been very high. Second, increased savings must have translated directly into increased capital outflows without involving any significant pick-up in real domestic investment within Japan. This is in marked contrast to the 1978 situation and requires explanation.

In fact, the high propensity to save out of the income gain can easily be explained in terms of the differing propensities to save of the different sectors of the economy, and the well-known tendency for consumer prices to fail to reflect lower import prices in Japan. As indicated earlier, the nominal income gain is the result of lower prices for imports which, theoretically, should result in lower prices of consumer goods domestically both directly, in the case of imported consumer goods and indirectly, where the lower cost of industrial inputs makes possible lower prices for domestically produced goods. Lower consumer prices should 'free-up' income which then becomes available for increased spending, in real terms, on domestic product. However, as has been widely noted and is illustrated in Chart 2, consumer price inflation in Japan has dropped only slightly in response to the plunge in wholesale prices and even steeper drop in import prices this year, as the income gain has been effectively captured by the corporate (including distribution) sector of the economy, and not passed on to the household sector. In turn the corporate sector in aggregate has not used this income gain to increase investment in real assets as the economy has weakened, the income instead being reflected in increased savings.

However, savings of the corporate sector, if placed in the Japanese financial system, could still theoretically become available to the household

sector through the intermediation of the banking system and, against the background of an appropriately accommodative monetary policy, could act to support consumer spending - particularly by those whose incomes are adversely affected by the weakness of the manufacturing export sector of the economy. Furthermore, the same phenomenon of divergence between wholesale price and consumer price inflation was also noticeable in 1978, albeit to a lesser extent (see Chart 2), and did not prevent a sharp recovery in real domestic spending at that time. Therefore, the failure of consumer prices to reflect lower import prices cannot realistically be accepted as the full explanation for the disappointing growth performance of domestic spending to date.

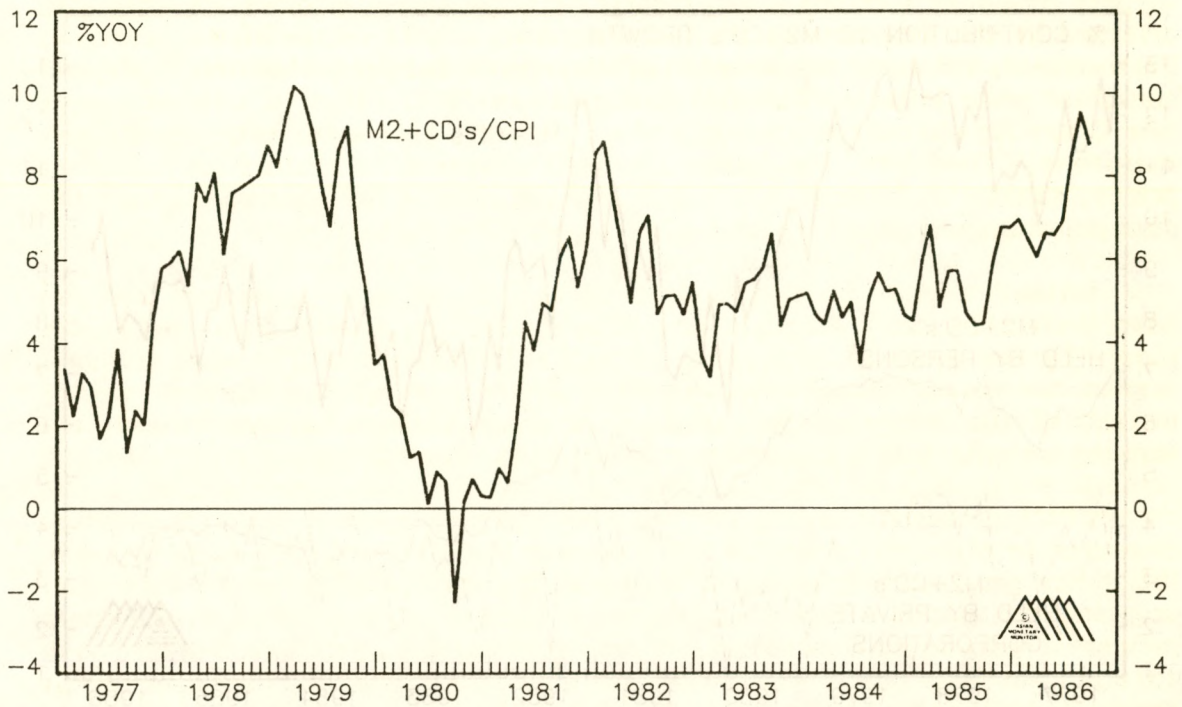
Instead, a major problem appears to be that monetary conditions in Japan have been effectively less accommodative than is apparent from the money supply figures taken at face value, as partial liberalisation of Japan's financial system has encouraged disintermediation on the part of the household sector instead of the intermediation of the corporate sector's savings through the banking system. This is illustrated in Charts 3, 4, 5 and 6.

Chart 3 shows a strong pick-up in the growth of real money supply (as measured by M2+CDs divided by the consumer price index) as the Bank of Japan (BOJ) has progressively eased monetary policy over the course of this year, dropping the discount rate from 5% to its current level of 3%. As the chart indicates, real money growth has not undergone quite such a marked upturn as in 1978 but nevertheless by August had reached similar levels to those achieved at the early 1979 peaks of the previous monetary cycle. However, Charts 4, 5 and 6, which examine the money supply and monetary growth by deposit holder, give a very different picture of liquidity trends when viewed specifically with reference to the personal sector. Chart 4 shows the year-on-year growth rates of demand, savings and time deposits (i.e. M2 not including cash currency) held by persons and those held by private corporations. The chart shows a marked downtrend in the growth rate of M2 held by persons since early 1982 and, most significantly, a 1.2% decline in the growth rate - from 8.1% to 6.9% - over the period from mid-1985 to the present. In contrast, the growth of that part of M2 held by private corporations, although very volatile on a monthly basis, can be seen to have been in a clearly defined uptrend since mid-1982 and a possibly steeper uptrend since mid-1985. To bring this into the context of the actual growth figures for overall M2+CDs, Chart 5 shows the growth of money held by persons and money held by private corporations as measured in terms of their contribution to the year-on-year growth in overall M2+CDs. In this chart certificates of deposit held by private corporations have been included in private corporations' money holdings to give a more complete picture and also to eliminate the effect of shifts in corporate funds from certificates of deposit to time deposits (which explain a small part of the acceleration in private corporations' holdings of M2 since mid-1985 observable in Chart 4). However the contribution of M2+CDs held by persons and M2+CDs held by private corporations do not exactly add to total M2+CD growth because of the non-inclusion of cash currency in circulation and the omission of the contribution from public deposits.

Chart 5 merely serves to bring into perspective the growth rates shown in Chart 4. It shows a significant change in the relative contributions of private corporations' and personal money holdings to overall money growth over the

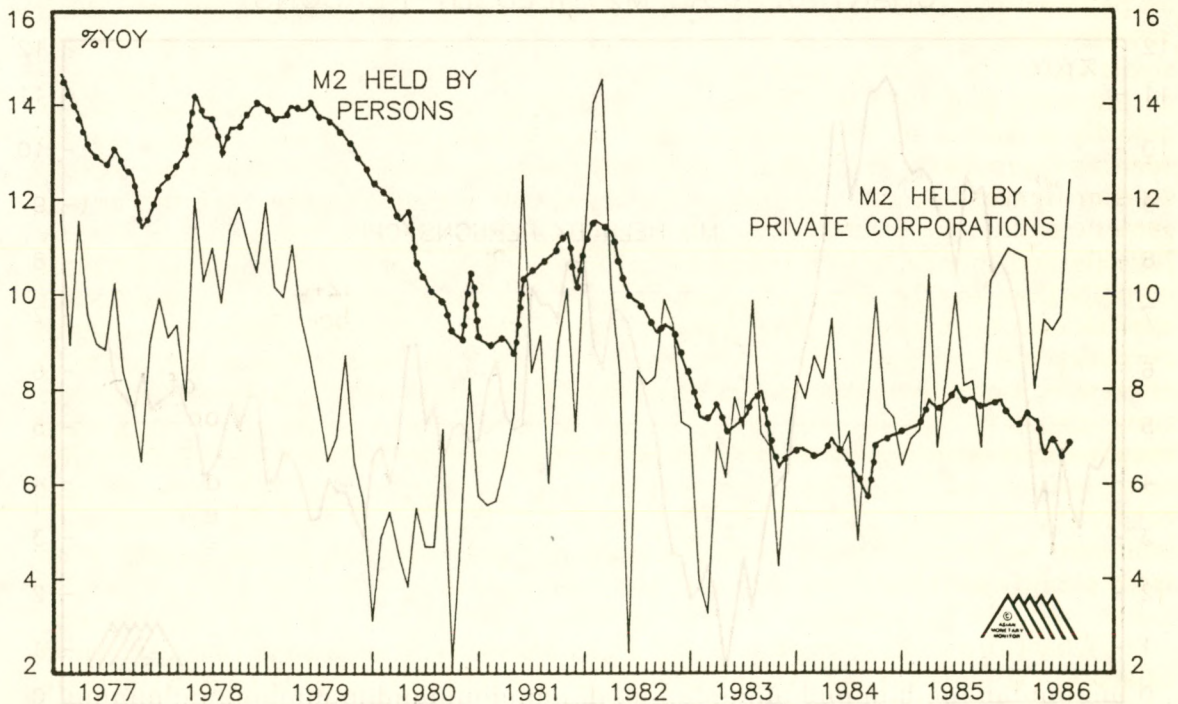
JAPAN

CHART 3: REAL MONEY SUPPLY (M2+CD's)



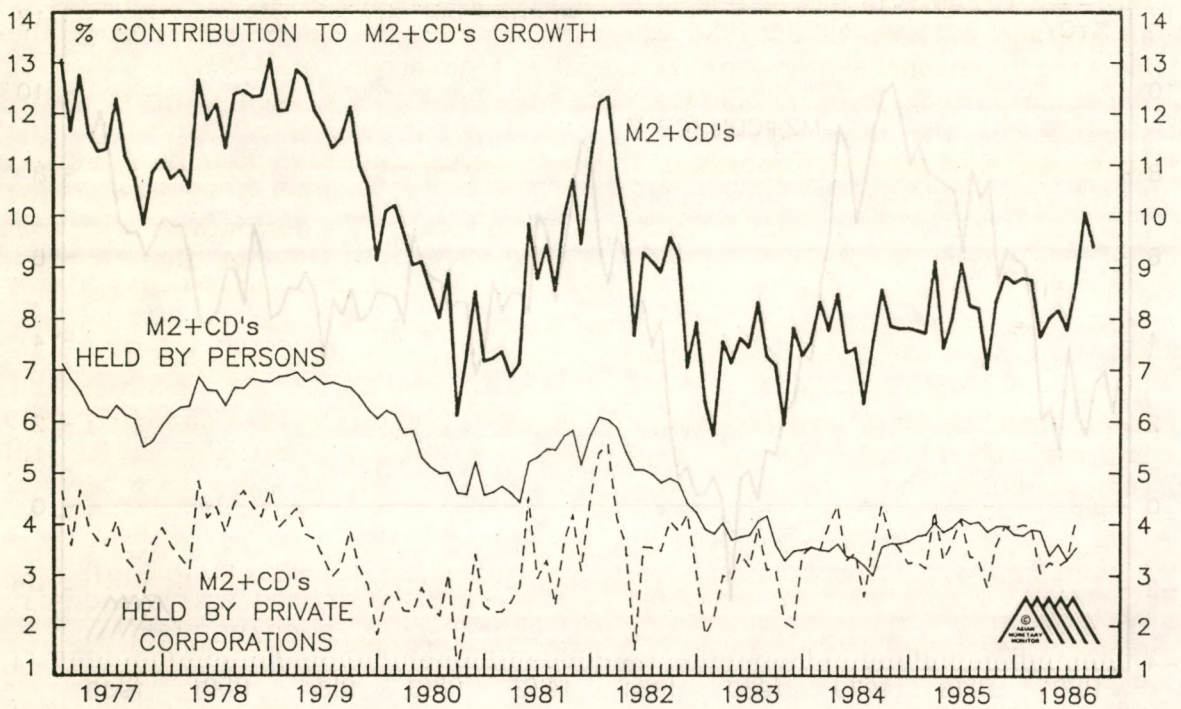
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CHART 4: GROWTH OF PERSONAL AND CORPORATE DEPOSITS



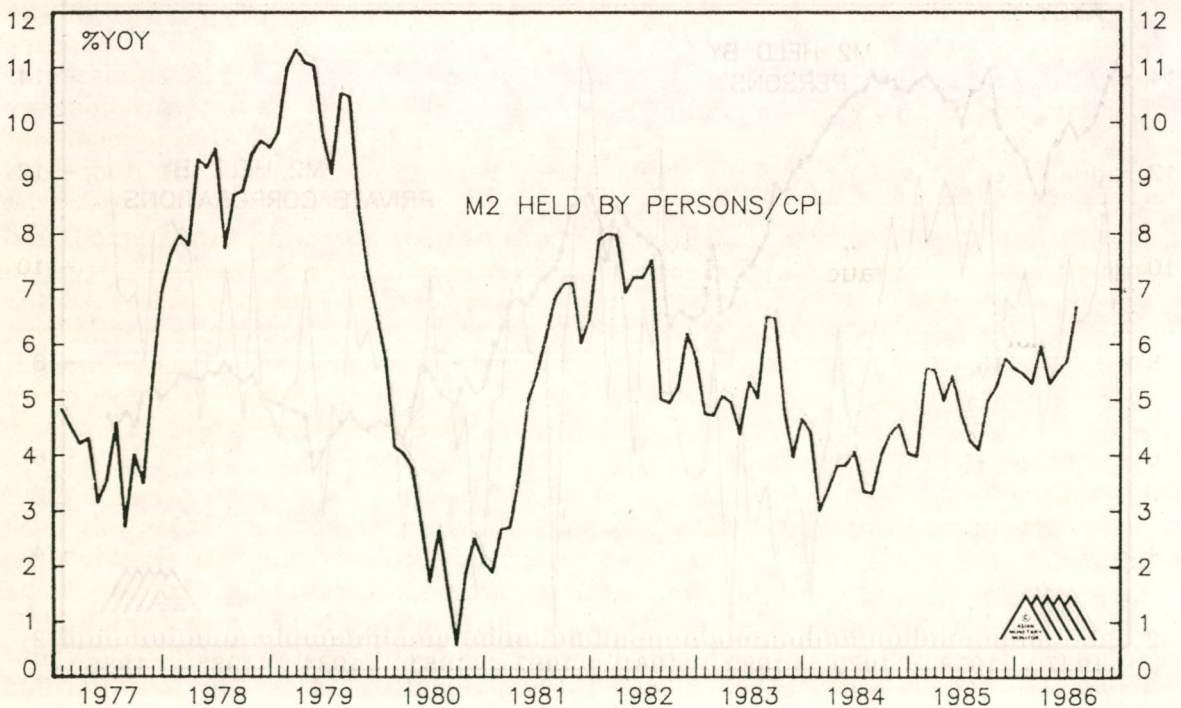
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CHART 5: M2+CD's GROWTH BY HOLDER



JAPAN

CHART 6: REAL M2 HELD BY PERSONS



period of the 1980s, when compared with the late 1970s. In particular, it can be seen that the contribution of the increase in private corporations' deposits to total M2+CD growth has increased from a rough average of 2.5%-3% in 1982 to an average of 3.5%-4% in 1986 whereas, in contrast, the contribution of the increase in personal sector deposits has fallen from around 4.5%-5% to 3.5% over the same period. In particular it can be noted that, in marked contrast to the situation of the late 1970s, in the most recent month of July 1986 the contribution of private corporations' deposit holdings to total M2+CD growth, at 4.1%, exceeded that of personal holdings, at 3.5%. Chart 6 focuses on the growth of real money held by persons in a form directly comparable with real M2+CDs shown in Chart 3. As is suggested by the previous three charts, although showing a gradual uptrend in real personal deposit growth since early 1984, the chart indicates a significantly less easy personal sector liquidity position than that implied by Chart 3. In particular, not only has the 3.7% increase in real personal sector deposit growth since early 1984 been markedly lower than the 8.6% increase which occurred between late 1977 and early 1979 but the current level of real personal sector deposit growth, at 6.7%, still remains below the early 1982 peak of 8.0%, let alone the early 1979 peak of 11.3%.

The divergence between corporate and personal sector liquidity and particularly the relative failure, compared with 1978, of household liquidity to respond favourably to an apparently very easy monetary environment can be explained in terms of the stage that has now been reached in the ongoing process of liberalisation of the Japanese financial system. Liberalisation officially began in 1976 with the official acknowledgement of the gensaki repurchase market. However, to all intents and purposes, in 1978 the Japanese financial system was still a fully regulated one, in which the financial institutions were segmented by the class, and in the case of the banks by the loan maturity, of the business they could conduct and all interest rates were effectively directly determined by the authorities, except those in the inter-bank call and bill markets and in the gensaki market. Bank deposit and loan rates were controlled by the Temporary Interest Rates Adjustment Law and guidelines provided by the BOJ. The issue of Certificates of Deposit was not authorised until May 1979. An active secondary market in government debt began to emerge from 1977-78 as the government gradually eased regulations which had previously allowed it to issue debt to a 'captive' syndicate of financial institutions at below-market rates (the institutions then being required to hold the bonds for a certain time period) and moved towards an auction system for the issuance of medium- and long-term government debt. However, a secondary market in Treasury Bills (in the traditional sense) did not exist until February of this year, when the Ministry of Finance moved to issue T-Bills at market rates, and a commercial paper market was not initiated until June 1985, when the yen-denominated bankers' acceptance market was inaugurated. Further, prior to December 1980 capital outflows from Japan were tightly controlled.

Deregulation of the Japanese financial system, which accelerated in 1984 following the "Japan-US Yen/Dollar Committee Report", has now reached the stage where market participants in all the key sectors of the economy have access to a fairly wide range of financial instruments bearing market yields. Amongst the liberalisations which have effectively permitted this development have been the liberalisation of foreign exchange controls under the New Foreign

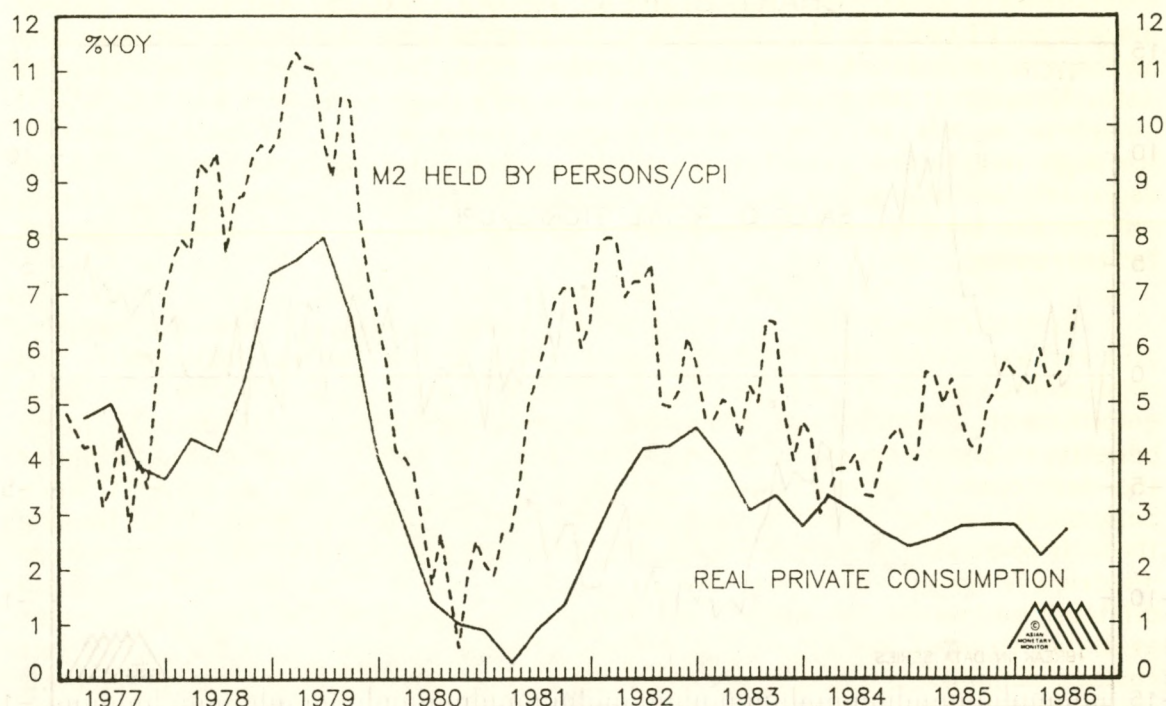
Exchange and Trade Control Law of December 1980, the authorisation of medium-term government bond funds in January 1980, the initiation of money market certificates in March 1985 and the gradual liberalisation of interest rates on large time deposits, beginning in October 1985. Nevertheless, deregulation to date, although it has given corporations (or very large borrowers and depositors) complete access to free market interest rates within the banking system (through negotiated loan rates and liberalised interest rates on large bank deposits), has only given individuals access to market rate-yielding instruments outside the traditional intermediation market, and then only for investing, not for borrowing.

In this respect, the consumer credit business, although expanding rapidly, still remains under-developed both as a result of institutional inflexibility and regulations, as well as the Japanese fiscal structure and the 'life-time employment' practice of companies (under which companies provide many benefits to their employees, including housing loans) which have tended to inhibit the development of mortgage loan business. Laws prohibit consumer finance companies raising funds in the market, instead restricting them to funding through borrowing from the banks, while loans from the city banks (which have historically tended to concentrate on corporate loan business) themselves remain difficult to obtain for many consumers. The result is that borrowing rates available to most individuals still remain very high (around 15% from consumer finance companies) and are insensitive to market interest rates. On the deposit side, deposits other than large time deposits still carry regulated interest rates, which have been significantly below market interest rates. Prior to the most recent (November 1st) reduction in the BOJ discount rate, ordinary deposits and installment savings deposits at the city banks carried interest rates of only 0.38% and 2.28% respectively. (Following the November 1 reduction in the discount rate, to 3.0%, BOJ reduced the ordinary deposit rate only marginally - to 0.26% - and left the installment savings rate unchanged, thus narrowing somewhat the differential between these interest rates and market interest rates.)

The result of this partial deregulation is that increasingly the personal sector has moved funds out of the banking system and into the burgeoning array of non-monetary financial vehicles carrying market-related yields such as medium-term government bond funds, mutual funds, trust funds and tax-efficient life insurance products. However, for the most part these funds invest in foreign or domestic securities thus effectively, in the first case, hastening the tendency for the country's incremental savings to be reflected directly in increased capital outflows without providing any immediate benefit to domestic expenditure or, in the second case, exacerbating the divergent trends of personal and corporate sector liquidity evident in Charts 4 and 5 (to the extent that companies tend to issue more equity to soak up demand, as share prices rise).

This is significant because there is a historically close relationship in Japan between personal sector liquidity and consumption spending (as demonstrated in Chart 7 with reference to real M2 held by persons compared to real private consumption). Furthermore, and most importantly, interest rates presently play largely only an indirect role in this relationship because of the insensitivity of consumer lending rates to market interest rates. Although falls in interest rates should nevertheless stimulate corporate investment and through this the

CHART 7: PERSONAL SECTOR LIQUIDITY AND CONSUMER SPENDING

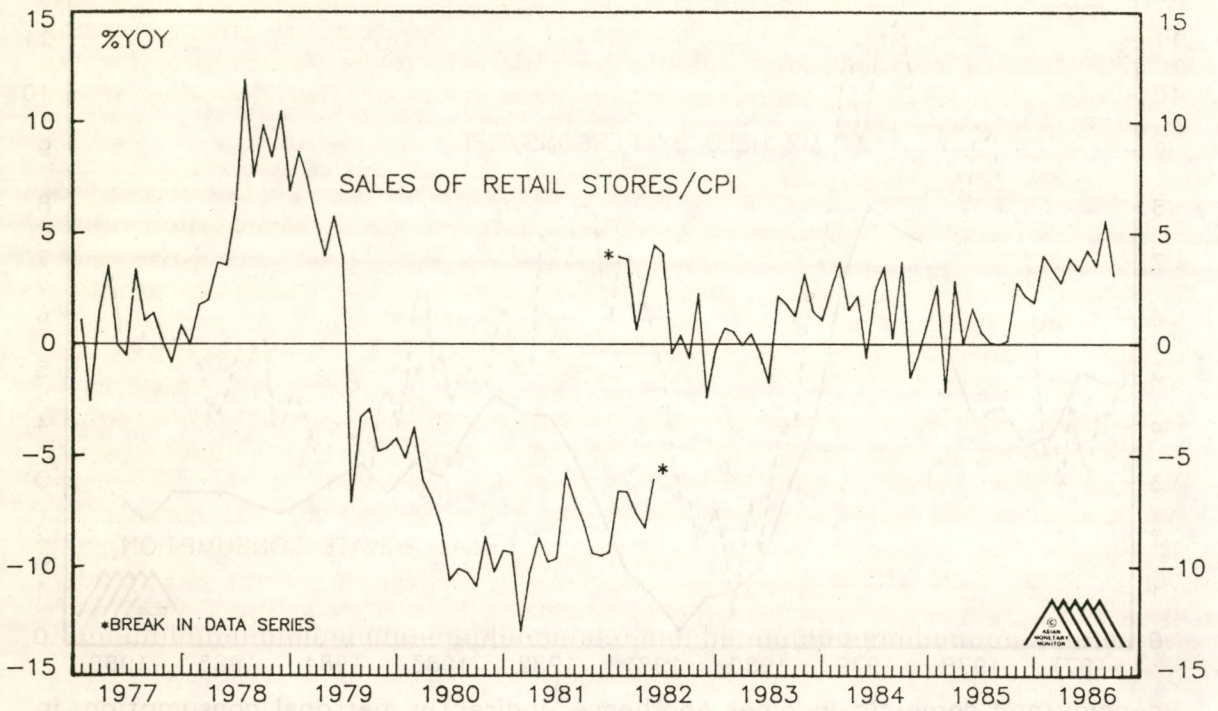


economy and domestic incomes and hence, indirectly, personal consumption, in the present weak export environment aggregate investment remains weak despite successive reductions in interest rates. Thus, not only is consumer spending not particularly benefiting even indirectly from the lower interest rates which have accompanied the terms of trade income gain and accommodative BOJ monetary policy, but it is being directly restrained by the adverse consequences for personal sector liquidity of disintermediation which has accompanied the incomplete liberalisation of the financial system. In other words, the combination of the corporate sector's capturing of the income gain resulting from the terms of trade improvement and partial financial deregulation has resulted in nearly all the benefits, in liquidity terms, of the accommodative monetary environment falling to the corporate sector, which has then accumulated financial assets rather than investing in real assets. This is, somewhat paradoxically, different from the situation in 1978, when total regulation of the financial sector meant that the only alternative to savings in the banks and post office, for most consumers at least, was spending, ultimately meaning that the trend in personal sector liquidity closely tracked that of corporate sector liquidity (see Chart 4) and fed more easily into increased consumption spending.

However, although domestic spending in Japan so far this year has been disappointing relative to 1978, the outlook is by no means all gloomy. Notwithstanding the problem of disintermediation, personal sector liquidity has shown some improvement as a result of the small drop in consumer price inflation that has filtered through, suggesting that there is room for an acceleration in consumer spending from current levels (see Chart 7). Further, certain consumer areas, such as department store sales, are already looking fairly firm when viewed in real terms (see Chart 8) and investment in the

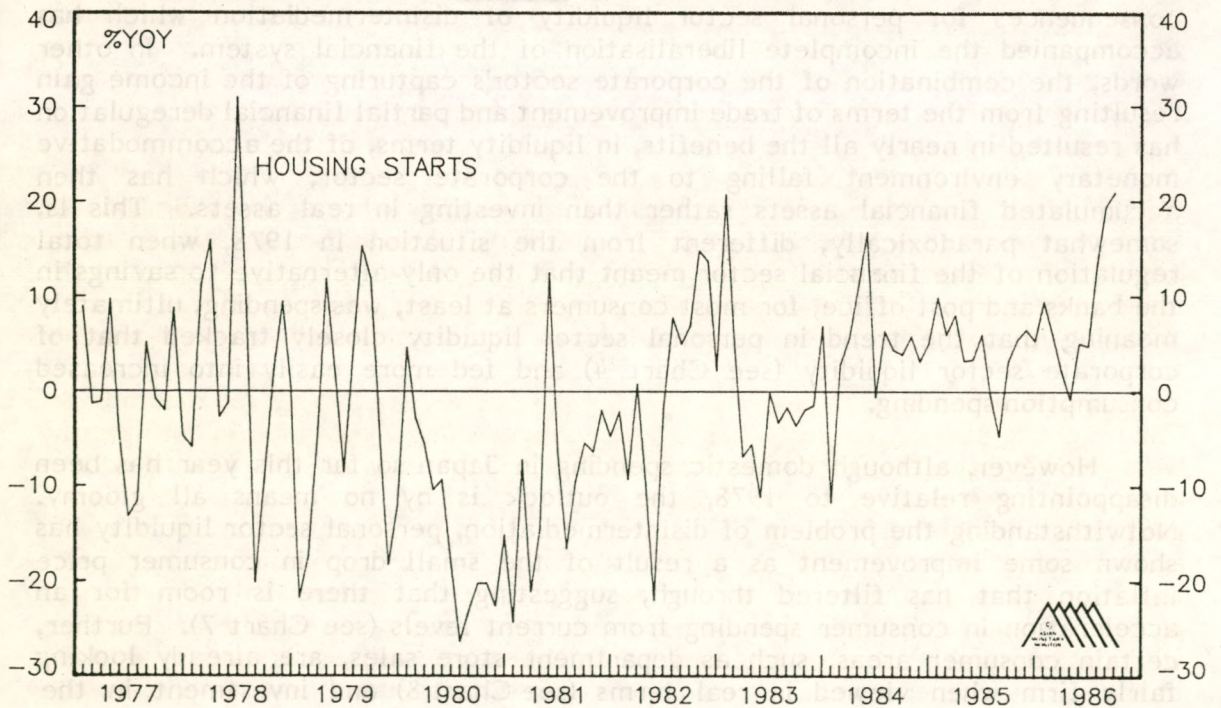
JAPAN

CHART 8: REAL RETAIL SALES



JAPAN

CHART 9: HOUSING STARTS



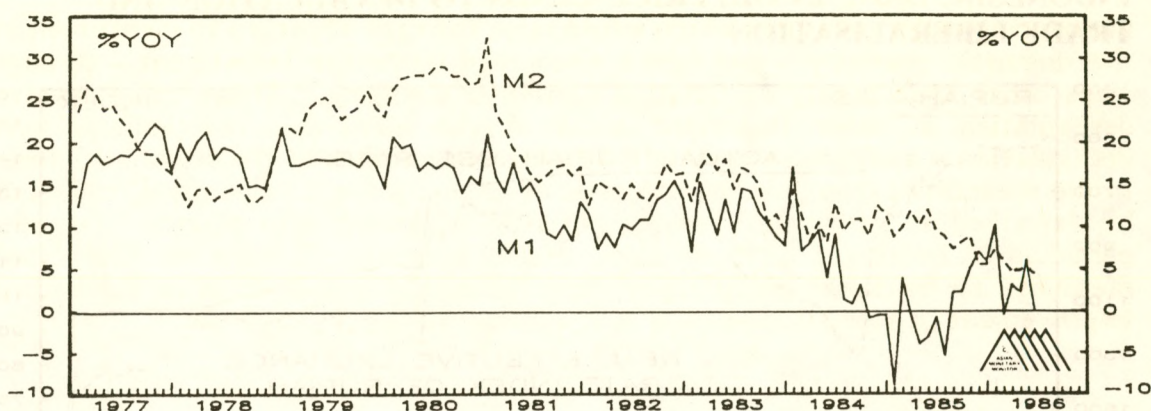
domestic sector of the economy has shown some strength. Most importantly, housing starts have recently shown very strong growth (see Chart 9). This latter is very important because housing is widely viewed as the single most important area of the domestic economy because of the likelihood of strong housing activity feeding into consumer durable spending (which has traditionally formed a smaller part of total consumer expenditure in Japan than in other major industrialised countries).

The discussion above suggests that a monetary solution to the problem of stimulating domestic spending would be to hasten further liberalisation of the financial system. Although this is likely to happen in time, the government appears likely to short-circuit the process by introducing a variety of measures which should have a more direct effect on stimulating domestic expenditure. A number of such measures have already been announced and implemented, and others are likely to be introduced next year. Amongst them are measures to reduce the well-known bias in the tax system in favour of savings (under which salaried workers can receive tax free interest on a potential maximum of up to Yen 14 million (US\$87,000) in savings but interest payments on borrowings are not deductible against tax) and reduce the progressivity of the income tax structure, which should stimulate consumption. A further measure which is being taken to encourage housing investment is the easing of terms of eligibility for housing loans from the government's Housing Loan Corporation. Even more important could be land deregulation and possible changes in the tax treatment of land sales which, in freeing up land for development and, most likely, leading to lower land prices, would have a major positive effect on commercial property and housing development and, in a more general sense, would help significantly in raising the return to investment in the domestic sector of the Japanese economy (discussed in AMM Vol. 10 No. 2). A full discussion of these, and other measures, which the government may take over the next year to encourage growth in the Japanese 'domestic' economy is beyond the scope of the present article, but it is clear that there are a number of fiscal and deregulatory options open to the government outside those pertaining just to the financial sector, and all of them could play a part in encouraging domestic economic growth within Japan against the background of the current accommodative monetary environment.

FORECAST: The performance of the Japanese economy in the wake of the stronger yen has been somewhat disappointing, as Japanese domestic spending has failed to show the strength necessary to compensate for weak exports in the manner in which it did in apparently similar circumstances in 1978. From a monetary perspective, the difference between Japan's present experience and that of 1978 can be explained in terms of the deregulation of Japan's financial system which has taken place, which while very extensive, is as yet incomplete. The resulting disintermediation by the personal sector, when taken in conjunction with the corporate sector's 'capturing' of the gain in national income consequent upon the improved terms of trade, has meant that the terms of trade income gain has translated directly into capital outflows from Japan and, in the process, an accumulation of liquidity in the corporate sector, but provided little benefit to domestic spending in Japan. The appropriate monetary solution to this problem would be for the authorities to retain accommodative monetary policies while hastening the process of financial deregulation. While this may be unlikely in the short-term, the government appears likely to short-circuit the problem by

introducing major measures which would raise the rate of return to investment in the domestic economy - and hence encourage corporate investment - through ways other than purely stimulating consumer spending. These could involve deregulation in other important areas of the economy - particularly land deregulation - and almost certainly will involve changes in the fiscal structure. In the meantime, growth in the domestic economy, while disappointing, could not be described as particularly weak, and signs of strength in important areas - particularly housing - have recently been emerging. It appears likely that measures to be taken by the government will be followed by a significant improvement in domestic spending over the course of the next year.

MALAYSIA: MONEY GROWTH SLOWS DESPITE CENTRAL BANK'S STIMULATORY ACTIONS



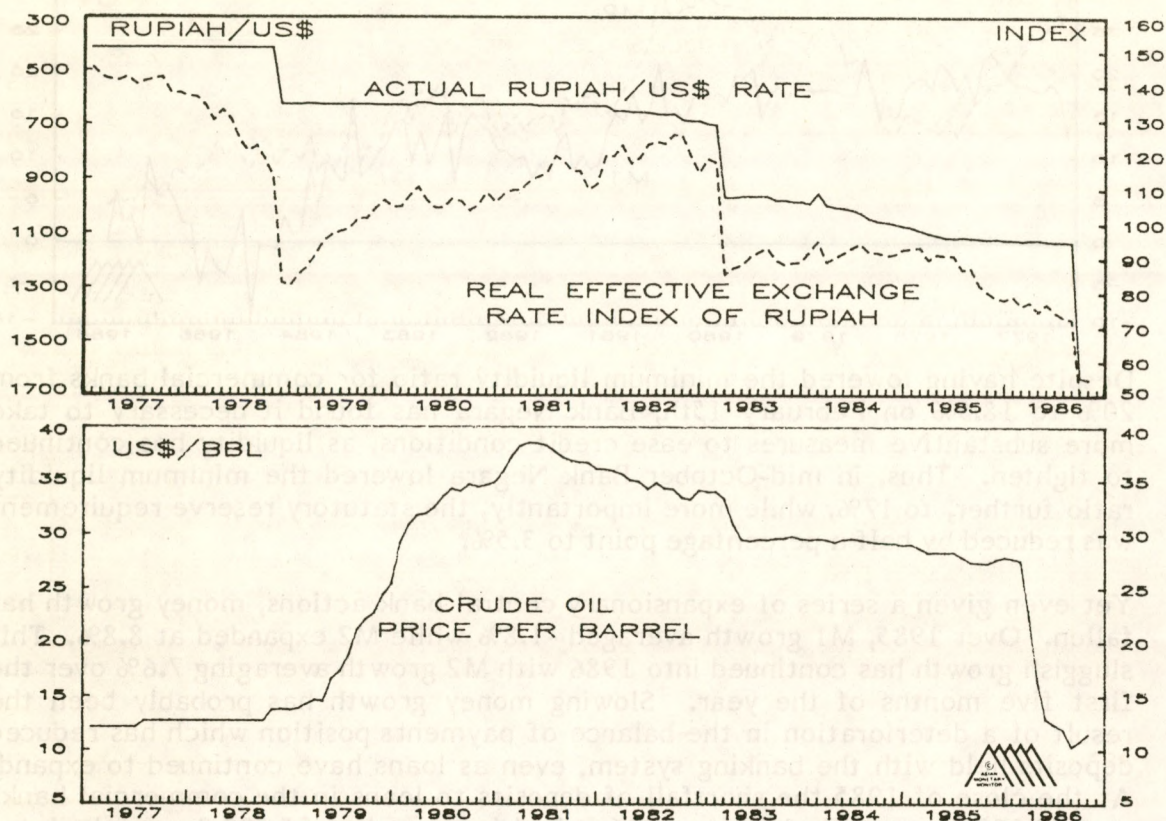
Despite having lowered the minimum liquidity ratio for commercial banks from 20% to 18.5% on February 15th, Bank Negara has found it necessary to take more substantive measures to ease credit conditions, as liquidity has continued to tighten. Thus, in mid-October Bank Negara lowered the minimum liquidity ratio further, to 17%, while more importantly, the statutory reserve requirement was reduced by half a percentage point to 3.5%.

Yet even given a series of expansionary central bank actions, money growth has fallen. Over 1985, M1 growth averaged -1.8% while M2 expanded at 8.8%. This sluggish growth has continued into 1986 with M2 growth averaging 7.6% over the first five months of the year. Slowing money growth has probably been the result of a deterioration in the balance of payments position which has reduced deposits held with the banking system, even as loans have continued to expand. At the close of 1985 the shortfall of deposits to loans in the commercial banks was \$3,128.5 mn while by May 1986 it had increased to \$5,099.3 mn, placing a squeeze on bank liquidity. The shortfall in deposits has been compounded by increased competition for deposits from the cooperatives and other institutions which has led to a withdrawal of money from the banking system. As a result, the contribution of fixed deposits to quasi money growth fell to only 0.6% in May 1986 compared to 27% in May 1985, although this dramatic decline should see some reversal in the wake of growing restrictions on the activities of deposit taking companies.

Faced with the continuing weakness in growth and to help stimulate the economy, Bank Negara has taken a series of stimulatory moves. As detailed above, reserve requirements have been altered on a number of occasions but part of this stimulatory effect was offset by an attempt to iron out the inequalities within the system. In April 1985 and February 1986 the statutory reserve requirement of the merchant banks was actually increased, partially offsetting the impact of the decline in requirements for the commercial banks. In addition, Bank Negara has directly injected funds into the banking system by moving government deposits from the central bank to the commercial banks. This was particularly noticeable in mid-1985 but also occurred earlier this year.

However, although money growth has remained sluggish and real interest rates have stayed high capital inflows are likely to lead to an easing of liquidity. Budget projections indicate a likely increase in public sector net foreign borrowing and this should add to the growth of the monetary base and reduce the pressure on liquidity.

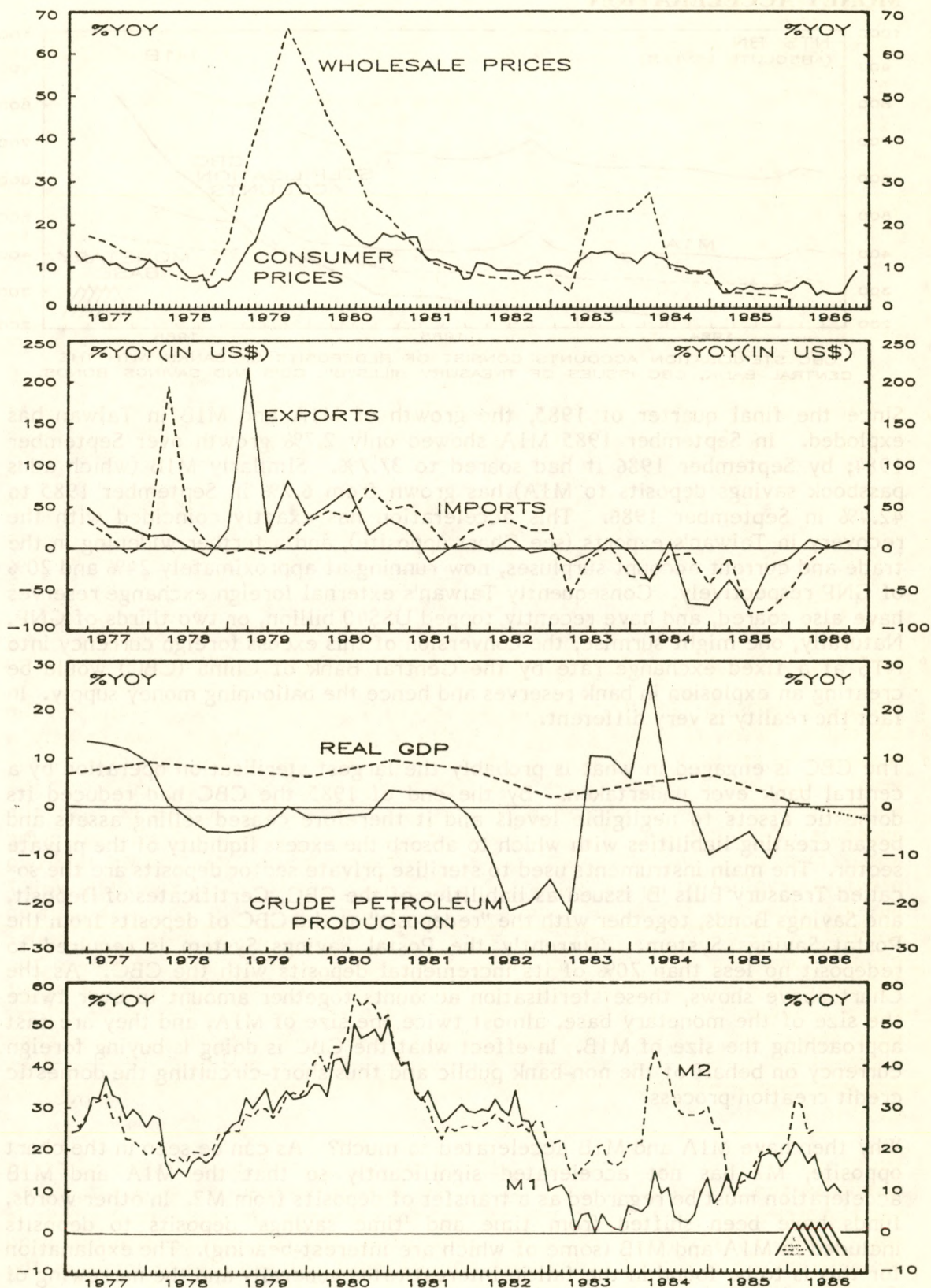
INDONESIA: DROP IN OIL PRICE LEADS TO DEVALUATION AND TRADE LIBERALISATION



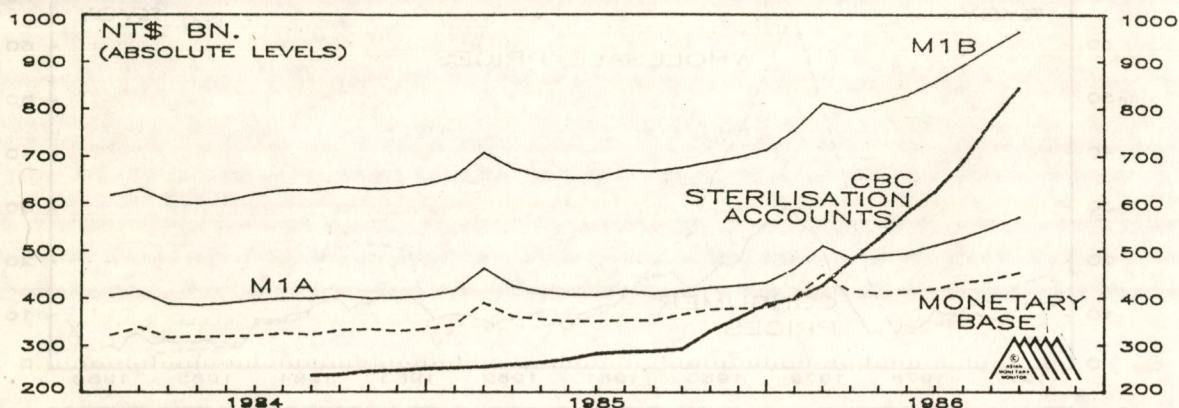
On September 12, 1986 the Indonesian Rupiah was devalued by 31% against the US dollar, from 1134 Rps./\$ to 1644 Rps./\$. This devaluation was purely a response to the fall in oil prices which has occurred since the beginning of the year. The above chart shows that the international competitiveness of the economy had actually increased before the devaluation, due largely to the appreciation of the yen. A possible danger is that the devaluation will only bring about high rates of money growth and inflation as happened after the two previous devaluations in 1978 and 1983. (See the opposite chart and AMM Vol. 7 No. 2.) However, it may be that this devaluation will have a lasting impact on competitiveness since it ratifies a change in the real price of Indonesia's major export. With earnings from oil and gas dropping from US\$12.44 billion in the 1985-86 fiscal year to an estimated US\$6.6 billion in 1986-87, the government hopes to increase non-oil exports and decrease imports with this move. Last year petroleum products provided approximately 70% of foreign exchange earnings and 60% of the government's revenue. The decline in foreign earnings and the consequent widening of the trade deficit helped reduce the growth in GDP to 1.3% for 1985 and growth is estimated at -1.1% for 1986.

Along with the devaluation, the government announced that it was going to liberalise the traded goods sector. Tariffs are to be reduced, as are the non-tariff barriers to trade. The government also strongly denied rumours that it was going to reimpose exchange controls. The trade liberalisation and devaluation are designed to help the non-oil exporters and also to increase the competition faced by domestic producers of many goods.

INDONESIA MONEY, OUTPUT, TRADE AND PRICES



TAIWAN: UNPRECEDENTED STERILISATION PREVENTS BROAD MONEY ACCELERATION

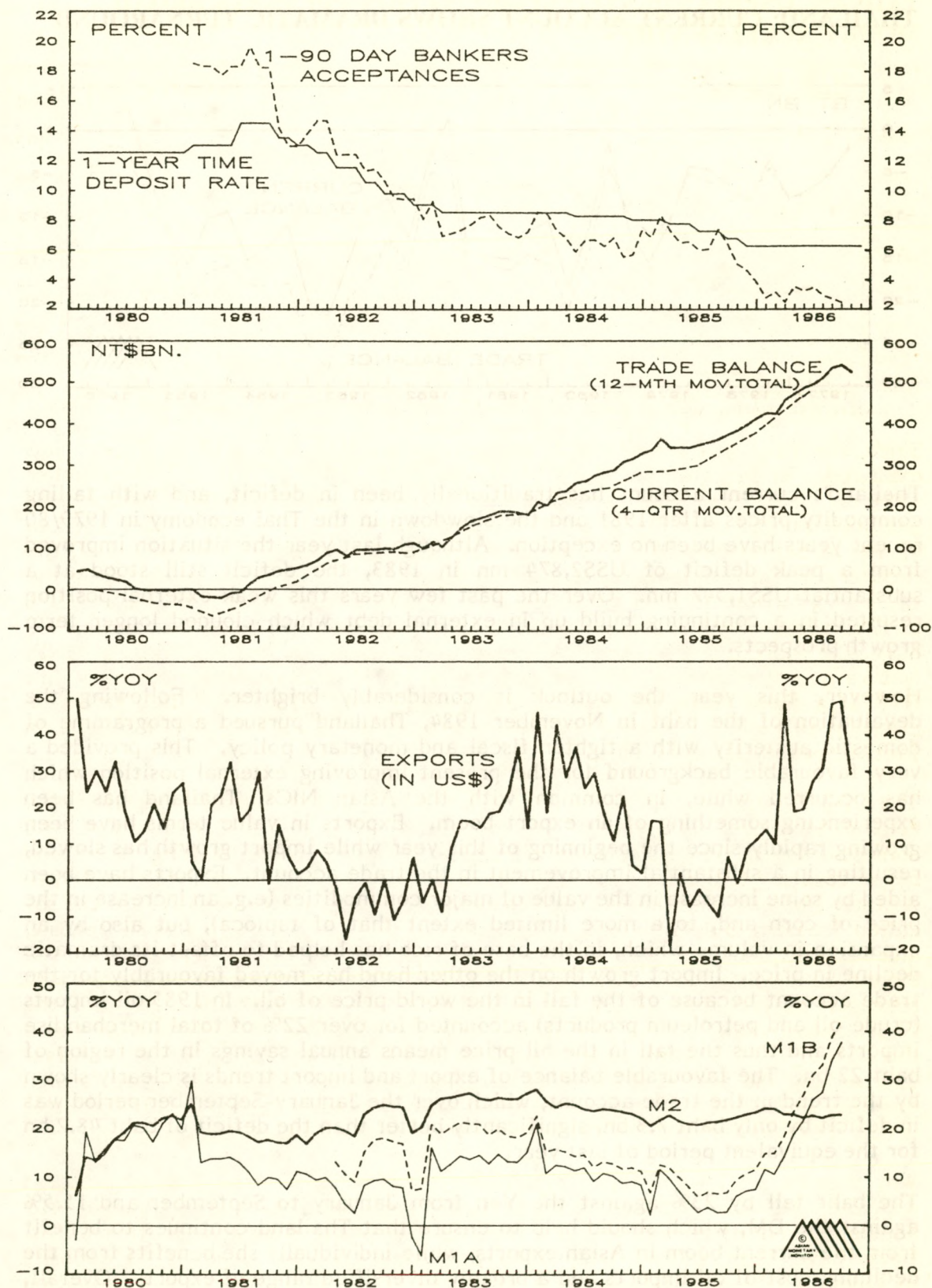


CBC STERILISATION ACCOUNTS CONSIST OF REDEPOSITS OF BANKS WITH THE CENTRAL BANK, CBC ISSUES OF TREASURY BILLS 'B', CD'S AND SAVINGS BONDS.

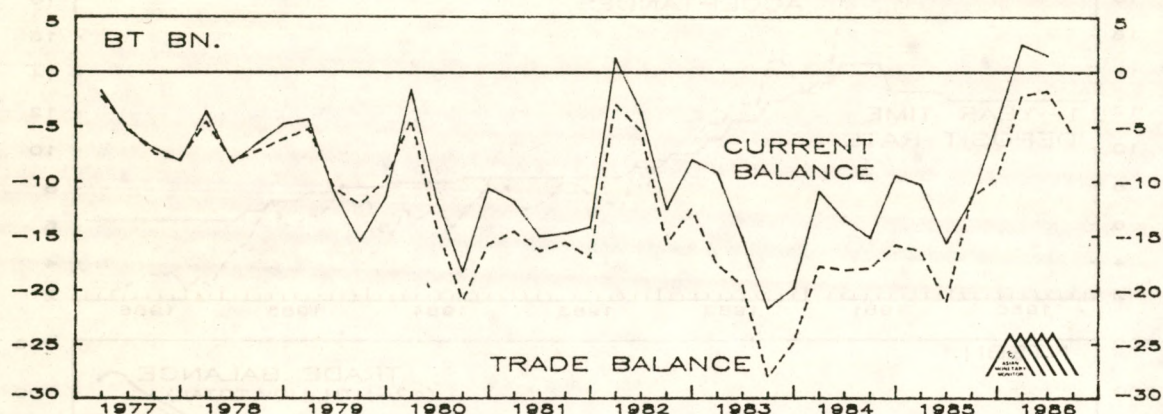
Since the final quarter of 1985, the growth of M1A and M1B in Taiwan has exploded. In September 1985 M1A showed only 2.7% growth over September 1984; by September 1986 it had soared to 37.7%. Similarly M1B (which adds passbook savings deposits to M1A) has grown from 6.7% in September 1985 to 42.4% in September 1986. This acceleration has exactly coincided with the recovery in Taiwan's exports (see Chart opposite), and a further widening in the trade and current account surpluses, now running at approximately 24% and 20% of GNP respectively. Consequently Taiwan's external foreign exchange reserves have also soared, and have recently topped US\$40 billion, or two thirds of GNP. Naturally, one might surmise, the conversion of this excess foreign currency into NT\$ at a fixed exchange rate by the Central Bank of China (CBC) would be creating an explosion in bank reserves and hence the ballooning money supply. In fact the reality is very different.

The CBC is engaged in what is probably the largest sterilisation operation by a central bank ever undertaken. By the end of 1985 the CBC had reduced its domestic assets to negligible levels and it therefore ceased selling assets and began creating liabilities with which to absorb the excess liquidity of the private sector. The main instruments used to sterilise private sector deposits are the so-called Treasury Bills 'B' issued as liabilities of the CBC, Certificates of Deposit, and Savings Bonds, together with the "redeposit" at the CBC of deposits from the Postal Savings System. Currently the Postal Savings System is required to redeposit no less than 70% of its incremental deposits with the CBC. As the Chart above shows, these sterilisation accounts together amount to over twice the size of the monetary base, almost twice the size of M1A, and they are fast approaching the size of M1B. In effect what the CBC is doing is buying foreign currency on behalf of the non-bank public and thus short-circuiting the domestic credit creation process.

Why then have M1A and M1B accelerated so much? As can be seen in the chart opposite, M2 has not accelerated significantly so that the M1A and M1B acceleration must be regarded as a transfer of deposits from M2. In other words, funds have been shifted from time and 'time savings' deposits to deposits included in M1A and M1B (some of which are interest-bearing). The explanation for this is to be found in the fall in interest rates generally and the narrowing of interest rate differentials between M1-type deposits and M2-type deposits.



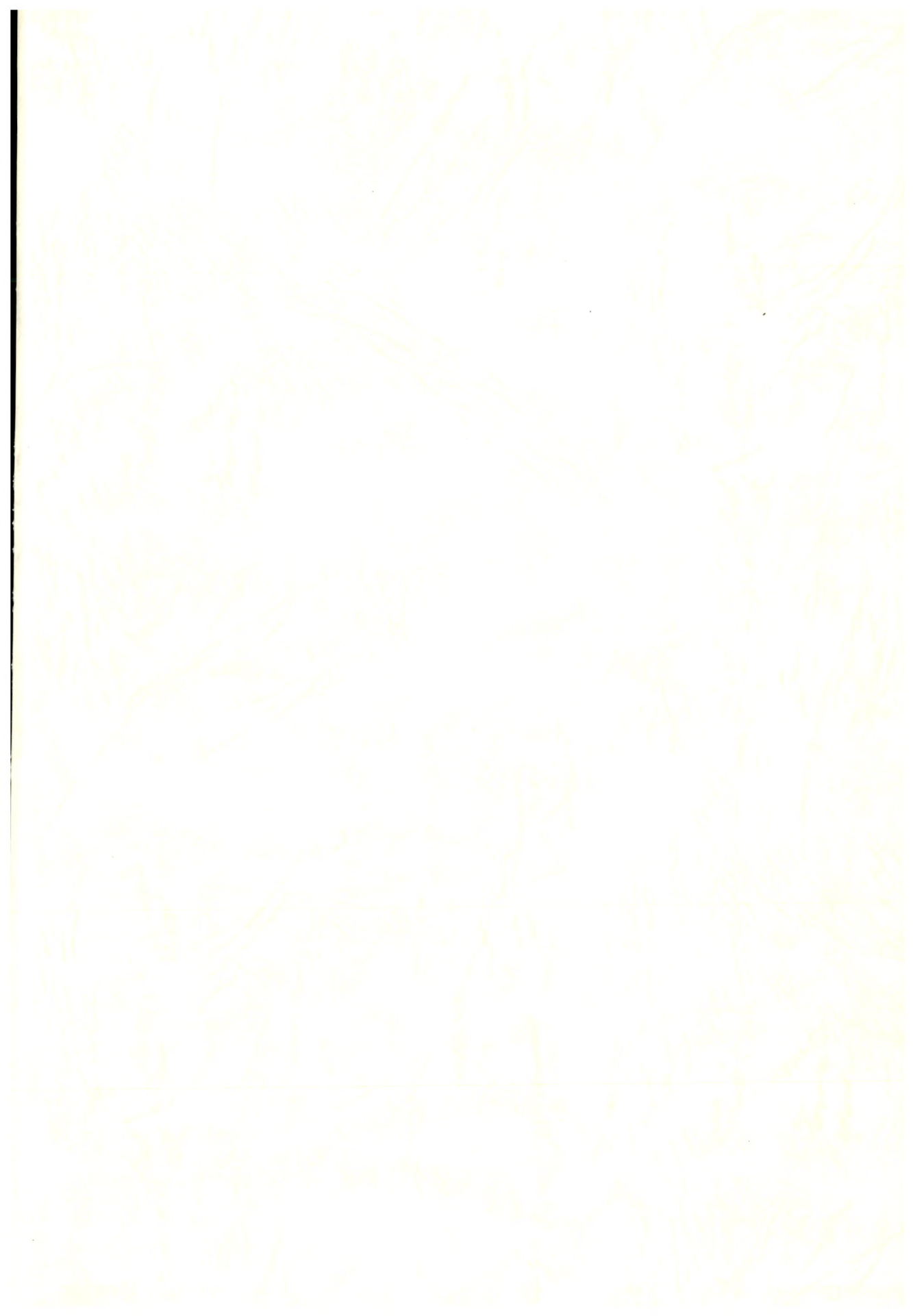
THAILAND: CURRENT ACCOUNT SHOWS DRAMATIC TURNAROUND



Thailand's current account has traditionally been in deficit, and with falling commodity prices after 1981 and the slowdown in the Thai economy in 1979/80 recent years have been no exception. Although last year the situation improved from a peak deficit of US\$2,874 mn in 1983, the deficit still stood at a substantial US\$1,547 mn. Over the past few years this weak external position resulted in a continuing build up in external debt which clouded longer term growth prospects.

However, this year the outlook is considerably brighter. Following the devaluation of the baht in November 1984, Thailand pursued a programme of domestic austerity with a tighter fiscal and monetary policy. This provided a very favourable background for the present improving external position which has occurred while, in common with the Asian NICs, Thailand has been experiencing something of an export boom. Exports in value terms have been growing rapidly since the beginning of this year while import growth has slowed, resulting in a substantial improvement in the trade account. Exports have been aided by some increase in the value of major commodities (e.g. an increase in the price of corn and, to a more limited extent that of tapioca), but also by an expansion in volume which, in the case of rice has helped to offset its dramatic decline in price. Import growth on the other hand has moved favourably for the trade account because of the fall in the world price of oil. In 1985 oil imports (crude oil and petroleum products) accounted for over 22% of total merchandise imports and thus the fall in the oil price means annual savings in the region of baht 22 bn. The favourable balance of export and import trends is clearly shown by the trend in the trade account, which over the January-September period was in deficit by only baht 7.3 bn, significantly better than the deficit of baht 48.2 bn for the equivalent period of last year.

The baht fell by 23% against the Yen from January to September and 15.5% against the DM, which should help to ensure that Thailand continues to benefit from the current boom in Asian exports, while individually she benefits from the declining cost of oil imports and a broadly diversified range of exports. Overall, this implies that Thailand's current account will improve dramatically from a deficit of baht 39 bn last year to register a surplus in the current year.





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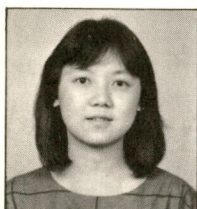
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KEYS TO SYMBOLS USED IN THE CHARTS

- % RP — Percentage Rate of change over Preceding period.
- % RS — Percentage Rate of change over Same period of preceding year.
- SA — Seasonally Adjusted.
- SAAR — Seasonally Adjusted at Annualised Rate.

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SINGAPORE: A REDUCTION IN CAPITAL OUTFLOWS WILL ALLOW FASTER MONETARY GROWTH

Between July 1985 and April 1986 the Singapore government implemented a major change in policy, effectively completely eliminating a huge public sector surplus which had been built up over a five year period of extraordinarily contractionary fiscal policies between 1980 and mid-1985. Given Singapore's institutional arrangements and the 'passive' policy of the Monetary Authority of Singapore (MAS) - involving purely the management and stabilisation of the Singapore dollar/US dollar exchange rate - a very significant reversal in monetary trends has been directly associated with this easing of fiscal policy. Over the period from 1980 (and particularly since 1983) to 1985 the public sector's burgeoning monetary surplus, representing an increasingly rapid build-up in public sector deposits with the MAS, had put constant downward pressure on the rate of monetary base and money supply growth. The rapid elimination of the public sector surplus over the past one and half years has now allowed a reversal of this trend, and as a result a substantial easing in liquidity conditions has taken place in Singapore since late 1985 (see Chart 1).

The detailed composition of the public sector's surplus over the 1980-85 period, and the relationship between the public sector's fiscal position and monetary growth has been the subject of a number of past AMM articles (AMM Vol. 8 No. 4, AMM Vol. 9 No. 2 and AMM Vol. 9 No. 5). In particular, the 1985-86 change in government policy, the associated reduction in the public sector's monetary surplus and the consequent expected major improvement in liquidity conditions was discussed in detail in the paper 'A Major Turning Point in Monetary Trends' in AMM Vol. 9 No. 5. The final extent of the fiscal policy change has ultimately proved to be more far-reaching than envisaged at the time of the publishing of the latter article, as it has included an unforeseen 'U-turn' on policy with respect to the Central Provident Fund (CPF). (This involved a sharp cut in the employers' contribution rate to the CPF from 25% to 10%, a recommendation which was contained in the final report of the government's Economic Committee, released in mid-February 1986.) However, the rate of monetary growth, although recovering sharply from -2.5%, 3.2%, and 1.7% as measured by M1, M2 and M3 respectively in October 1985 to 10.0%, 9.7% and 7.6% by September 1986, has nevertheless picked up somewhat less than expected. In this light, this article examines the factors which have determined the money growth rate in Singapore this year, and from this draws conclusions about the likely trend in liquidity in Singapore in 1987.

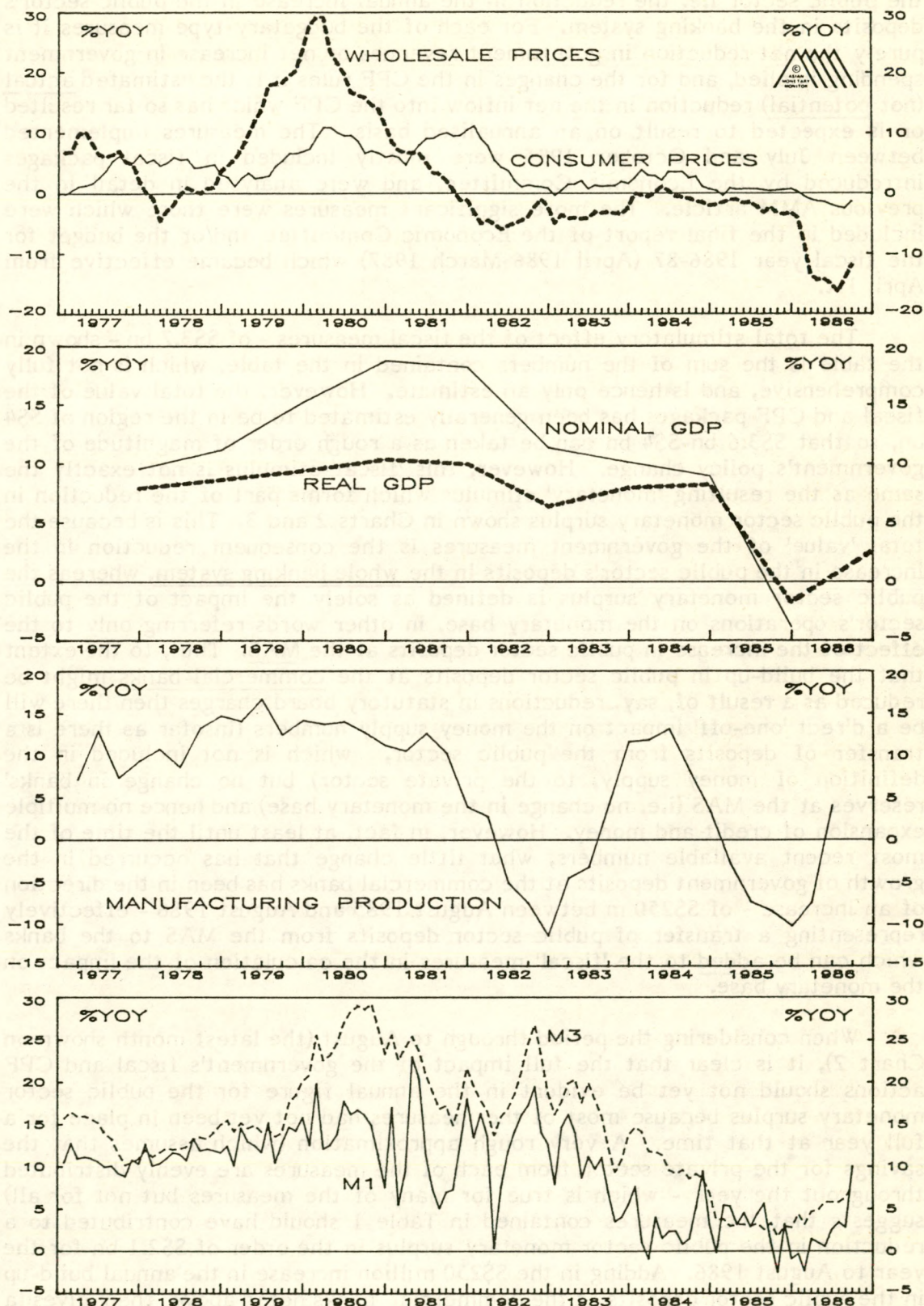
The key measures announced by the government between July 1985 and March 1986 are summarised in Table 1, along with the estimated 'value', on an annualised basis, of each of the packages of measures. 'Value' here refers to the

TABLE 1

THE GOVERNMENT'S POLICY CHANGE
MAIN FISCAL MEASURES, JULY 1985-OCTOBER 1986

	Measures	Estimated Annual 'Value'
July 1985	Reductions in statutory board (PSA, Telecoms, JTC, HDB, Civil Aviation) charges 30% property tax rebate for owner-occupied industrial & commercial properties; 2 year freeze on government land sales; S\$100 m venture capital fund; reduced rates on Economic Development Board loans to small business; speeding up of public sector infrastructural projects Relaxation of CPF rules for investment in private residential properties	S\$120 m S\$330 m
August 1985	Extension of property tax rebate to owners of rented industrial & commercial properties; reduction of duty on petrol, abolition of duty on fuel oil and cancellation of proposed diesel tax on taxis	S\$400 m
October 1985	Reduction in electricity and gas rates	S\$175 m
April 1986	Reduction in the employers' contribution rate to the CPF from 25% to 10% Reduction in the corporate tax rate from 40% to 33% 25% personal income tax rebate Increase in the property tax rebate from 30% to 50%	S\$1,700 m S\$420 m S\$250 m S\$100 m
May 1986	Individuals permitted to invest 20% of their CPF balance above a minimum reserve of S\$30,000 in trustee stocks or gold (subject to a 5% limit), potentially releasing S\$2.4 bn of CPF funds Extension of the CPF Approved Properties Scheme to cover non-residential properties	S\$200 m
July 1986	Tax exemption for land under private development	N/A
October 1986	Limit on CPF funds which can be invested in local equities or gold raised from 20% to 40% above the minimum reserve of S\$30,000 with the ceiling for gold raised to 10%, potentially releasing a further S\$2.4 bn of CPF funds TOTAL	N/A S\$3,700 m

SINGAPORE: CHART 1
MONEY, OUTPUT AND PRICES

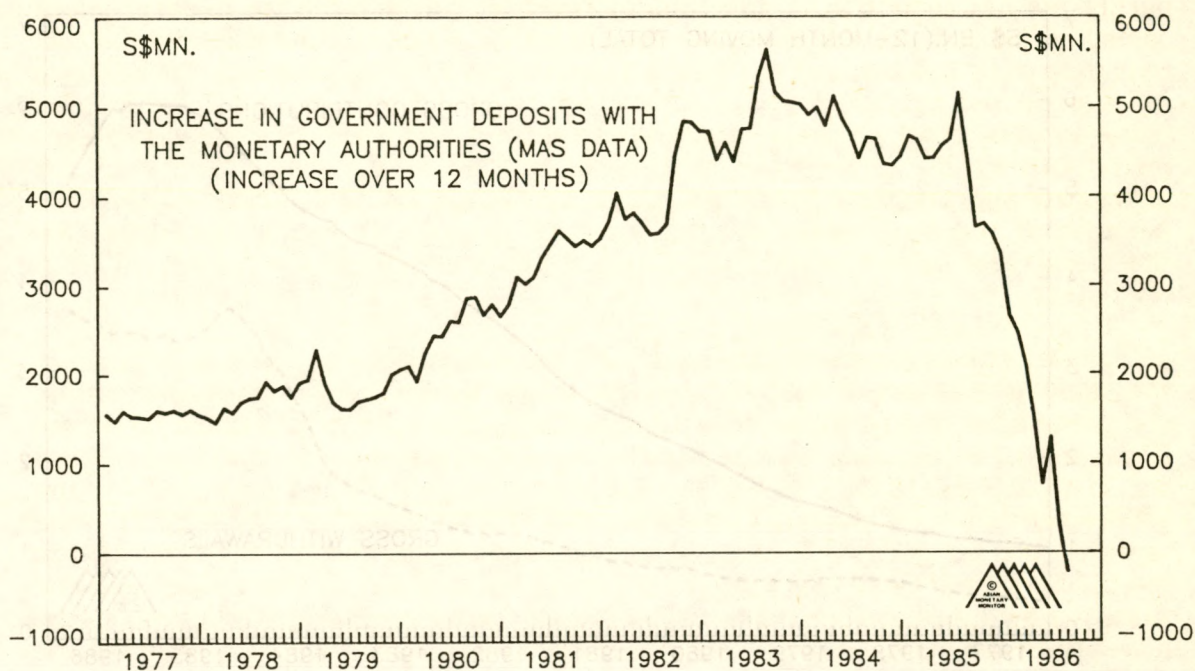


estimated resulting reduction in the monetary flow from the private sector to the public sector i.e. the reduction in the annual increase in the public sector's deposits in the banking system. For each of the budgetary-type measures it is purely the net reduction in government revenues or net increase in government spending implied, and for the changes in the CPF rules it is the estimated actual (not potential) reduction in the net inflow into the CPF which has so far resulted or is expected to result on an annualised basis. The measures implemented between July and October 1985 were mostly included in fiscal packages introduced by the Economic Committee, and were analysed in detail in the previous AMM article. The more significant measures were those which were included in the final report of the Economic Committee and/or the budget for the fiscal year 1986-87 (April 1986-March 1987) which became effective from April 1st.

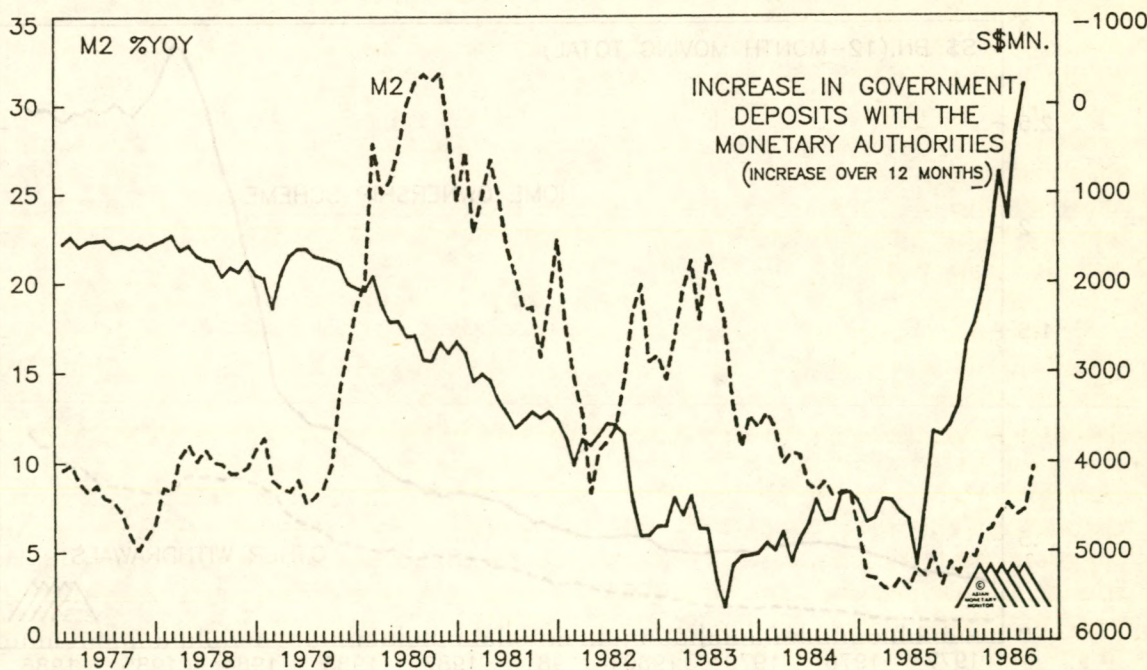
The total stimulatory effect of the fiscal measures - of S\$3.7 bn - shown in the table is the sum of the numbers contained in the table, which is not fully comprehensive, and is hence only an estimate. However, the total value of the fiscal and CPF packages has been generally estimated to be in the region of S\$4 bn, so that S\$3.6 bn-S\$4 bn can be taken as a rough order of magnitude of the government's policy change. However, this 'fiscal' stimulus is not exactly the same as the resulting 'monetary' stimulus which forms part of the reduction in the public sector monetary surplus shown in Charts 2 and 3. This is because the total 'value' of the government measures is the consequent reduction in the increase in the public sector's deposits in the whole banking system, whereas the public sector monetary surplus is defined as solely the impact of the public sector's operations on the monetary base, in other words referring only to the effect of the increase in public sector deposits at the MAS. Thus, to the extent that the build-up in public sector deposits at the commercial banks might be reduced as a result of, say, reductions in statutory board charges then there will be a direct 'one-off' impact on the money supply numbers (insofar as there is a transfer of deposits from the public sector, which is not included in the definition of money supply, to the private sector) but no change in banks' reserves at the MAS (i.e. no change in the monetary base) and hence no multiple expansion of credit and money. However, in fact, at least until the time of the most recent available numbers, what little change that has occurred in the growth of government deposits at the commercial banks has been in the direction of an increase - of S\$250 m between August 1985 and August 1986 - effectively representing a transfer of public sector deposits from the MAS to the banks which can be added to the 'fiscal' measures in the calculation of the impact on the monetary base.

When considering the period through to August (the latest month shown on Chart 2), it is clear that the full impact of the government's fiscal and CPF actions should not yet be evident in the annual figure for the public sector monetary surplus because most of the measures had not yet been in place for a full year at that time. A very rough approximation (which assumes that the savings for the private sector from each of the measures are evenly distributed throughout the year - which is true for many of the measures but not for all) suggests that the measures contained in Table 1 should have contributed to a reduction in the public sector monetary surplus in the order of S\$2.1 bn for the year to August 1986. Adding in the S\$250 million increase in the annual build-up in the public sector deposits at the commercial banks noted above then gives a

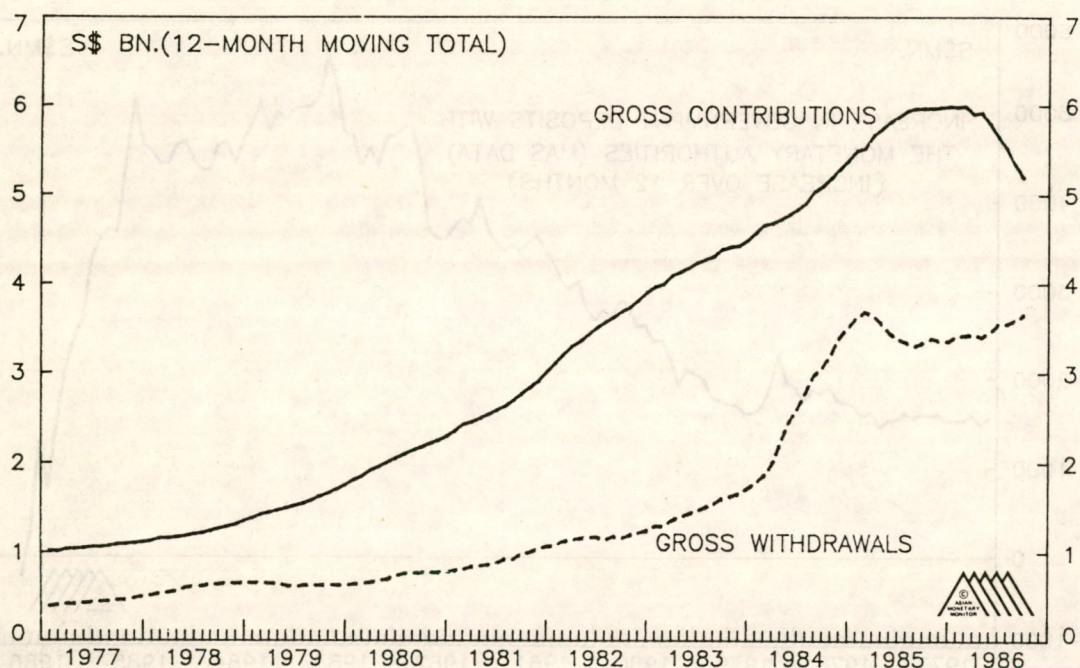
SINGAPORE: CHART 2
PUBLIC SECTOR MONETARY SURPLUS



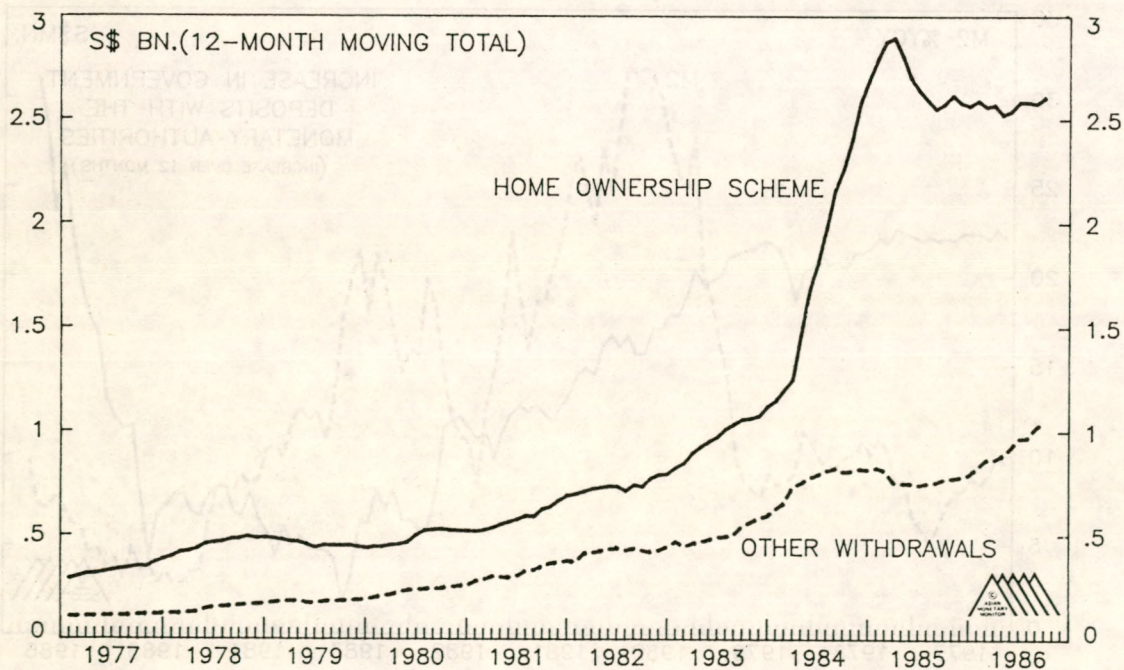
SINGAPORE: CHART 3
THE IMPACT OF THE PUBLIC SECTOR'S OPERATIONS UPON MONEY GROWTH



SINGAPORE: CHART 4
CONTRIBUTIONS TO AND WITHDRAWALS FROM THE C.P.F.



SINGAPORE: CHART 5
C.P.F. WITHDRAWALS



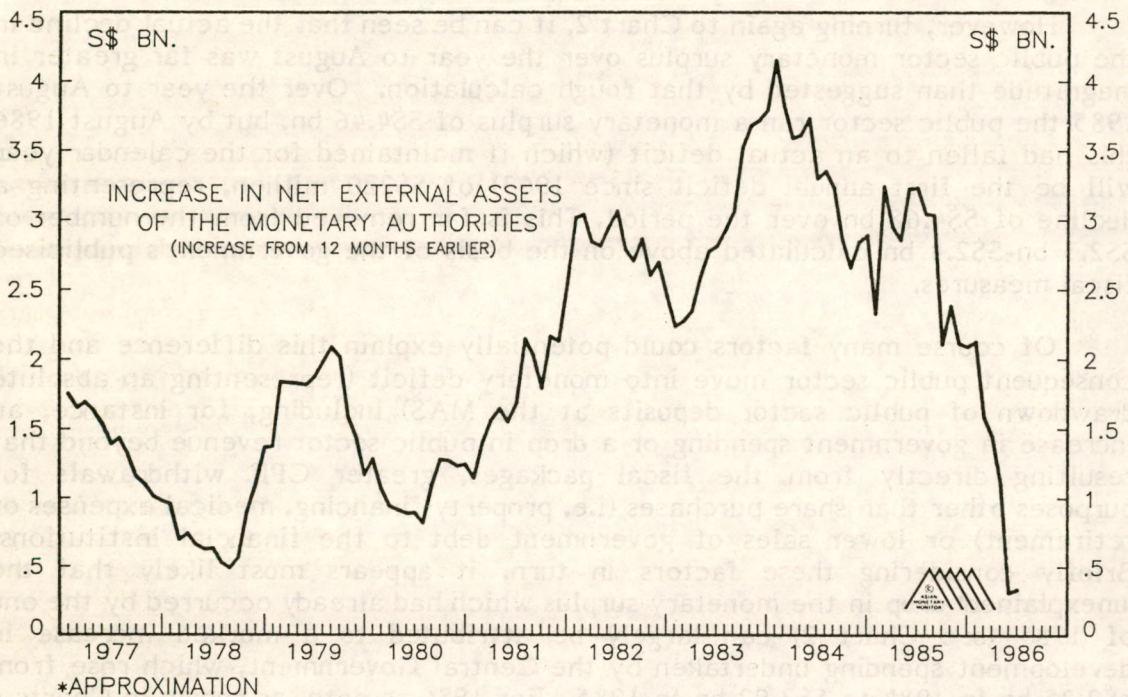
potential decline in the public sector monetary surplus of S\$2.3 bn - S\$2.4 bn over the year between August 1985 and August 1986 attributable to these sources.

However, turning again to Chart 2, it can be seen that the actual decline in the public sector monetary surplus over the year to August was far greater in magnitude than suggested by that rough calculation. Over the year to August 1985 the public sector ran a monetary surplus of S\$4.46 bn, but by August 1986 this had fallen to an actual deficit (which if maintained for the calendar year will be the first annual deficit since 1963) of S\$220 million, representing a decline of S\$4.68 bn over the period. This is far removed from the number of S\$2.3 bn-S\$2.4 bn calculated above on the basis of the government's publicised fiscal measures.

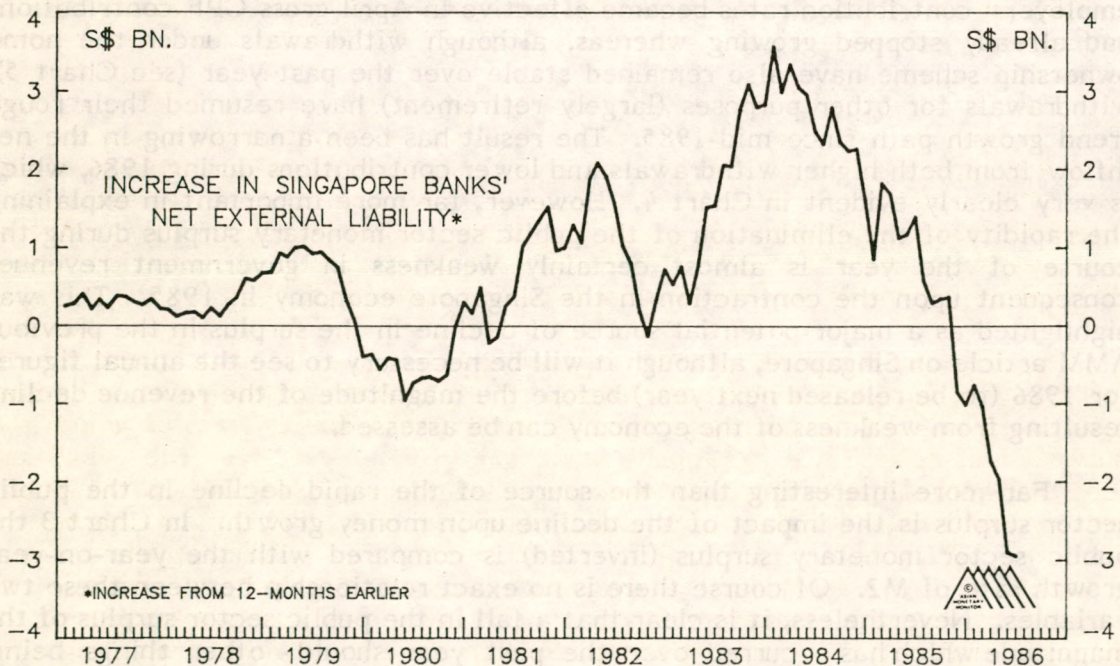
Of course many factors could potentially explain this difference and the consequent public sector move into monetary deficit (representing an absolute drawdown of public sector deposits at the MAS) including, for instance, an increase in government spending or a drop in public sector revenue beyond that resulting directly from the fiscal packages, greater CPF withdrawals for purposes other than share purchases (i.e. property financing, medical expenses or retirement) or lower sales of government debt to the financial institutions. Briefly considering these factors in turn, it appears most likely that the 'unexplained' drop in the monetary surplus which had already occurred by the end of 1985 (see Chart 2) can largely be attributed to a marked increase in development spending undertaken by the Central Government, which rose from S\$2.25 bn in 1984 to S\$3.92 bn in 1985. For 1986 to date, as shown in Charts 4 and 5, a small part of the decline (approximately S\$200 million) in the public sector monetary surplus can be attributed to a fall in the CPF net inflow (gross contributions minus gross withdrawals on Chart 4) beyond that arising purely from the cut in the contribution rate for employers and the introduction of the share investment scheme. As Chart 4 indicates, even before the cut in employers' contribution rates became effective in April gross CPF contributions had already stopped growing whereas, although withdrawals under the home ownership scheme have also remained stable over the past year (see Chart 5), withdrawals for other purposes (largely retirement) have resumed their rough trend growth path since mid-1985. The result has been a narrowing in the net inflow from both higher withdrawals and lower contributions during 1986, which is very clearly evident in Chart 4. However, far more important in explaining the rapidity of the elimination of the public sector monetary surplus during the course of the year is almost certainly weakness in government revenues consequent upon the contraction in the Singapore economy in 1985. This was highlighted as a major potential source of decline in the surplus in the previous AMM article on Singapore, although it will be necessary to see the annual figures for 1986 (to be released next year) before the magnitude of the revenue decline resulting from weakness of the economy can be assessed.

Far more interesting than the source of the rapid decline in the public sector surplus is the impact of the decline upon money growth. In Chart 3 the public sector monetary surplus (inverted) is compared with the year-on-year growth rate of M2. Of course there is no exact relationship between these two variables. Nevertheless, it is clear that a fall in the public sector surplus of the magnitude which has occurred over the past year should - other things being

SINGAPORE: CHART 6
OVERALL BALANCE OF PAYMENTS*



SINGAPORE: CHART 7
THE MONETARY CAPITAL INFLOW/OUTFLOW



equal - have been expected to lead to a much larger increase in the money supply growth rate than has actually occurred. In fact the total sizes of M2 and M3 are only S\$29.5 bn and S\$37.9 bn, respectively, so that even in the absence of any money multiplier, the transfer of the S\$4.46 bn public sector monetary surplus for the year to August 1985 to the private sector by August 1986 alone should have contributed to at least 12%-13% money supply growth for that one year period.

In reality, however, the public sector's monetary position is only one of two components of monetary base, and hence money supply growth, in Singapore - albeit the most important one over the last four years. The only other important factor determining money supply growth is the balance of payments position which, under Singapore's heavily managed exchange rate regime, impacts the monetary base via the MAS' foreign exchange interventions as the monetary authority acts to stabilise the Singapore dollar against the US dollar. Thus the reason that money supply growth has failed to pick-up as much as suggested by the huge fall in the public sector's monetary surplus is that Singapore's overall external payments position has deteriorated sharply.

The marked deterioration in the overall balance of payments surplus, approximated on Chart 6 by the increase in the net external assets (i.e. foreign exchange reserves) of the monetary authorities, has not been the result of any worsening in Singapore's trade position - which has actually improved slightly as, in common with the other NICs, Singapore has benefited from a favourable export environment - but has been because of a sharp adverse swing in the capital account, specifically related to monetary capital flows or capital flows into and out of the banking sector. A monetary capital inflow is defined as an increase in the net foreign liabilities of the commercial banks, meaning that the commercial banks incur liabilities to non-resident entities (possibly as a result of import trade transactions, overseas borrowings, or deposits from overseas) which are ultimately matched on the assets side of their balance sheets by claims on entities which are resident in Singapore. Conversely, a monetary capital outflow occurs when the commercial banks increase their net foreign assets (as a result of export trade, overseas lending or withdrawal of deposits held by foreign entities). From Chart 7 it can be seen that Singapore's monetary capital account has undergone a huge adverse swing from early 1984 to the present. In January 1984 the Singapore banks were accumulating net external liabilities at an annual rate of S\$3.6 bn but by June 1986 they were increasing net external assets at a rate of S\$3.0 bn, representing a S\$6.5 bn deterioration in Singapore's monetary capital account over the period. This far more than explains the deterioration in the overall balance of payments position illustrated in Chart 6.

In Singapore's case monetary capital flows into and out of the domestic banking sector are almost totally 'explained' by changes in the banks' net inter-bank position with the Asian Currency Units (ACUs). This is an issue which was discussed in detail in a previous AMM (AMM Vol. 8 No. 1). The ACUs are separate accounting units of banks and other financial institutions in Singapore set up to transact in the Asian dollar market. Thus their main business is accepting US dollar deposits from non-residents and lending them to non-residents in the Asian region, and as such they operate largely externally to Singapore's domestic monetary system. However, they do have access to the domestic market, being able to accept foreign currency deposits from Singapore

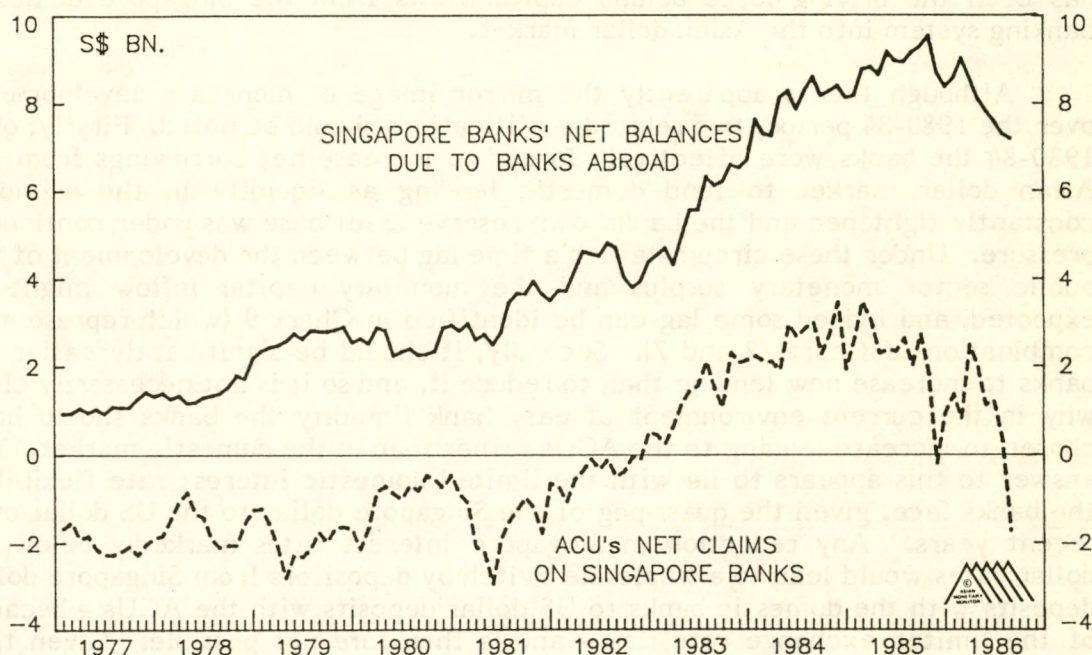
residents and make foreign currency loans to residents, and carry significant inter-bank positions with the domestic banks.

Chart 8 illustrates the Singapore banks' absolute net liability to banks abroad including the ACUs (the twelve month increase/decrease in which represents the net capital inflow/outflow from or to foreign banks, which is the largest part of the overall monetary capital inflow or outflow illustrated in Chart 7) and the corresponding net claims on the Singapore banks of the ACUs. From the chart it can be seen that in mid-1985 the ACUs were net lenders to the Singapore banks of an amount in excess of S\$2 bn but by August 1986 they had switched to being net borrowers of a similar amount, a swing that in itself can more than account for the net monetary capital outflow of nearly S\$3 bn in the year to mid-1986 indicated by Chart 7. Similarly, the S\$2.8 bn monetary capital inflow for 1983 (year to December) was largely explained by the increase in the ACUs' net claims on the Singapore banks during that year.

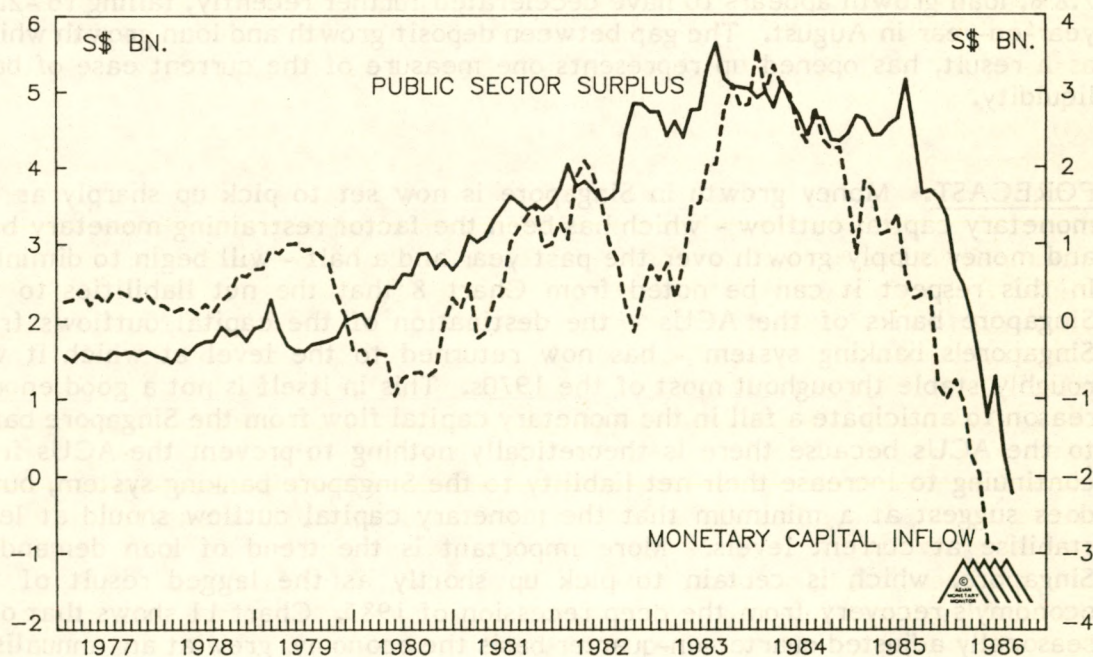
Thus the monetary impact of the public sector's shift from huge surplus to deficit over the past one and half years has been to quite a large degree offset by an adverse swing of similar magnitude in monetary capital flows between Singapore's domestic banking sector and the Asian dollar market, as the ACUs have switched from being significant net lenders to the Singapore banks to being significant net borrowers from them. Because the Asian dollar market is a US dollar market these ACU net borrowings must fund US dollar assets and therefore effectively represent a conversion of Singapore dollars into US dollars. Further, because the MAS acts to keep the Singapore dollar trading within a very narrow band against its US counterpart, the effect of this capital outflow will ultimately be felt on the authorities' foreign exchange reserves and hence on the monetary base - as the MAS is effectively forced to 'supply' the US dollars to finance the outflow - rather than on the exchange rate for the Singapore dollar.

It is evident that the deterioration in the monetary capital account has not occurred independently of the elimination of the public sector's monetary surplus. In fact the two are closely connected, and indeed the relationship between the rising public sector surplus and rising monetary capital inflow over the 1980-84 period (which occurred as the increasing government drain on liquidity drew capital from the Asian dollar market into Singapore) was discussed in depth in AMM Vol. 9 No. 5. To a degree, what has taken place over the past year and a half represents a reversal of this process. However, it is not necessarily obvious why the Singapore banks should have used reserves made available by the declining public sector surplus to increase lending to the ACUs rather than to increase new domestic lending. In this respect it is interesting to note that demand for loans from the ACUs themselves has been comparatively weak. Over the year to August ACU loans to non-bank customers grew by only 6.9%, down from a 10.9% year-on-year growth rate at the end of 1985. Further, deposits of non-bank customers at the ACUs have been growing very rapidly - at a 26.5% year-on-year rate in August - suggesting that Singapore domestic bank lending to the ACUs has not arisen as a result of any difficulty that the ACUs have faced in funding their own lending. Instead, the growth of ACUs' liabilities to the domestic banks, as well as the growth in the ACUs' deposit base, has funded the growth in 'other assets' of the ACUs - a residual item on the balance sheet. This points clearly to the conclusion that Singapore bank lending to the

SINGAPORE: CHART 8
ACU CLAIMS ON SINGAPORE BANKS



SINGAPORE: CHART 9
PUBLIC SECTOR SURPLUS AND THE MONETARY CAPITAL INFLOW



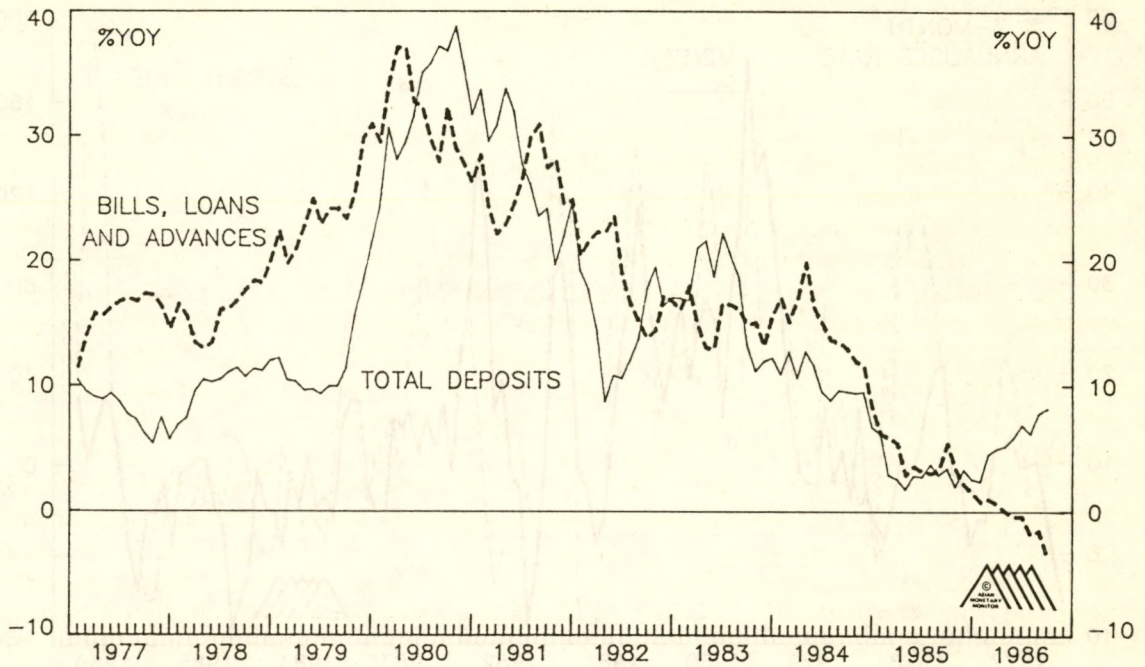
ACUs must have arisen because it has formed a convenient use of funds in an environment of very easy bank liquidity in the Singapore banking system i.e. easy bank liquidity in Singapore rather than tight liquidity in the Asian dollar market has been the driving force behind capital flows from the Singapore domestic banking system into the Asian dollar market.

Although this is apparently the mirror image of monetary developments over the 1980-84 period, two related qualifications should be noted. Firstly, over 1980-84 the banks were effectively forced to increase net borrowings from the Asian dollar market to fund domestic lending as liquidity in the economy constantly tightened and the banks' own reserve asset base was under continuous pressure. Under these circumstances a time lag between the development of the public sector monetary surplus and the monetary capital inflow might be expected, and indeed some lag can be identified in Chart 9 (which represents a combination of Charts 2 and 7). Secondly, it should be significantly easier for banks to increase new lending than to reduce it, and so it is not necessarily clear why in the current environment of easy bank liquidity the banks should have chosen to increase lending to the ACUs rather than in the domestic market. The answer to this appears to lie with the limited domestic interest rate flexibility the banks face, given the quasi-peg of the Singapore dollar to the US dollar over recent years. Any reduction in Singapore interest rates markedly below US dollar rates would lead to a wholesale switch by depositors from Singapore dollar deposits with the domestic banks to US dollar deposits with the ACUs - because of the limited exchange rate risk - and is therefore not possible. Given that Singapore interest rates are therefore largely externally determined, domestic loan demand will depend upon the demand for loans at the given interest rates, which in turn will be largely a lagged function of the strength of the economy.

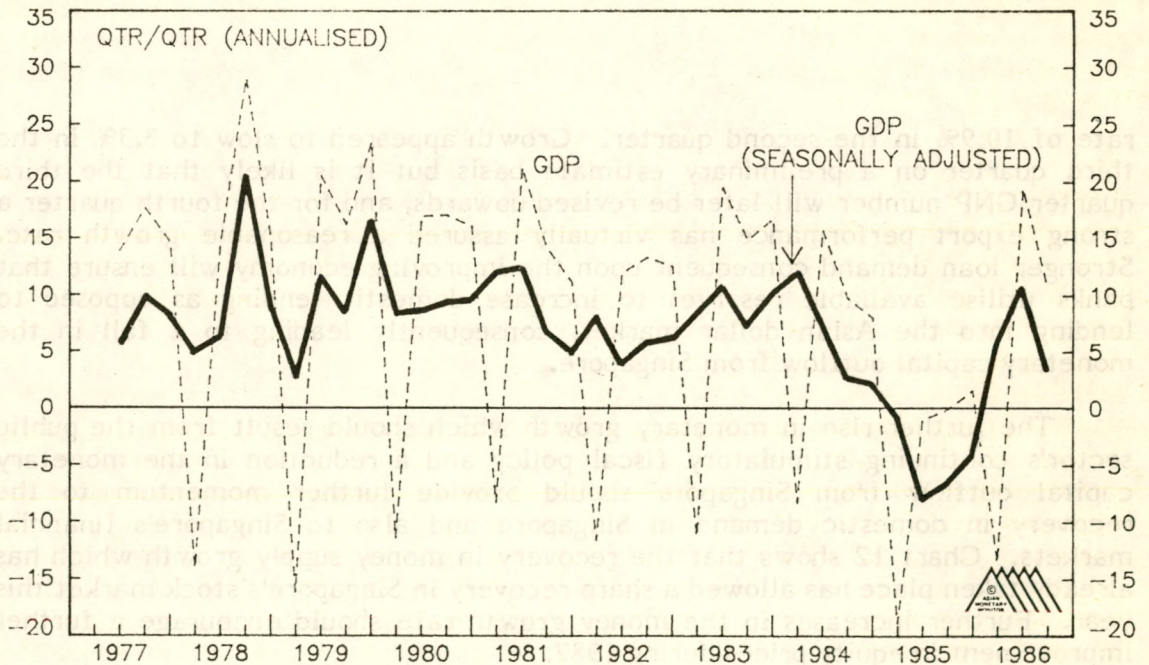
The problem here is highlighted by Chart 10, which shows the year-on-year growth rates of bank loans and deposits in Singapore. From the Chart it can be seen that although the annual growth rate of total deposits has now risen to 7.8%, loan growth appears to have decelerated further recently, falling to -2.0% year-on-year in August. The gap between deposit growth and loan growth which, as a result, has opened up represents one measure of the current ease of bank liquidity.

FORECAST: Money growth in Singapore is now set to pick up sharply as the monetary capital outflow - which has been the factor restraining monetary base and money supply growth over the past year and a half - will begin to diminish. In this respect it can be noted from Chart 8 that the net liabilities to the Singapore banks of the ACUs - the destination of the capital outflows from Singapore's banking system - has now returned to the level at which it was roughly stable throughout most of the 1970s. This in itself is not a good enough reason to anticipate a fall in the monetary capital flow from the Singapore banks to the ACUs because there is theoretically nothing to prevent the ACUs from continuing to increase their net liability to the Singapore banking system, but it does suggest at a minimum that the monetary capital outflow should at least stabilise at current levels. More important is the trend of loan demand in Singapore, which is certain to pick up shortly as the lagged result of the economy's recovery from the deep recession of 1985. Chart 11 shows that on a seasonally adjusted quarter-on-quarter basis the economy grew at an annualised

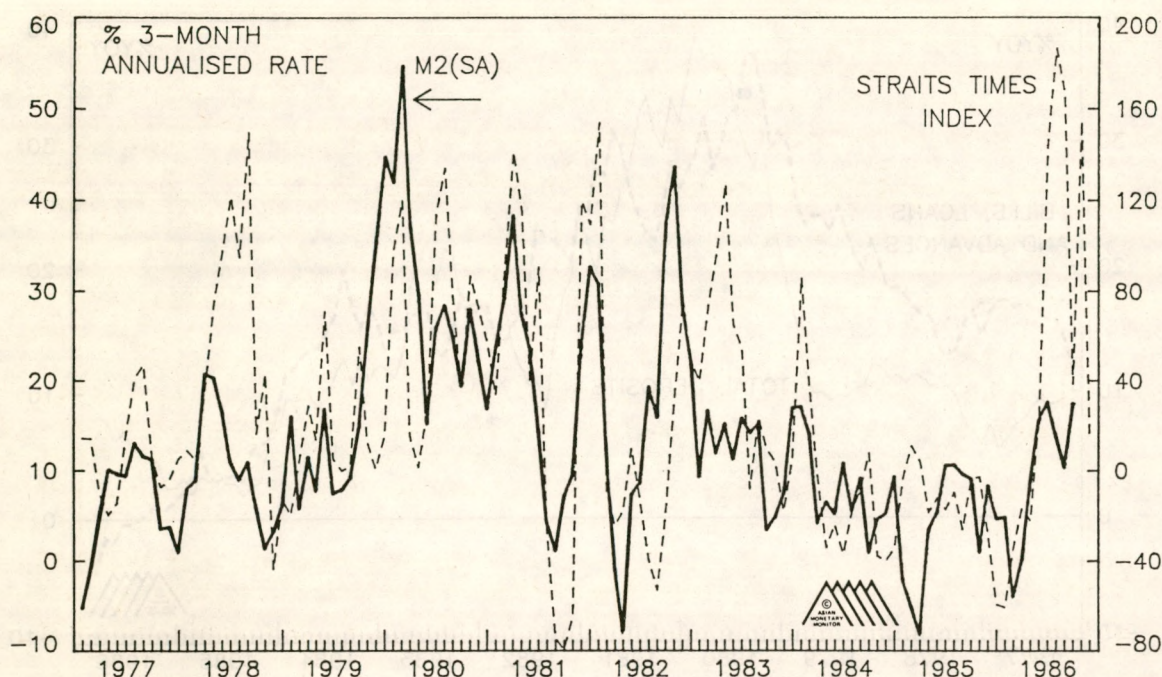
SINGAPORE: CHART 10
BANK LOANS AND DEPOSITS



SINGAPORE: CHART 11
GROSS DOMESTIC PRODUCT



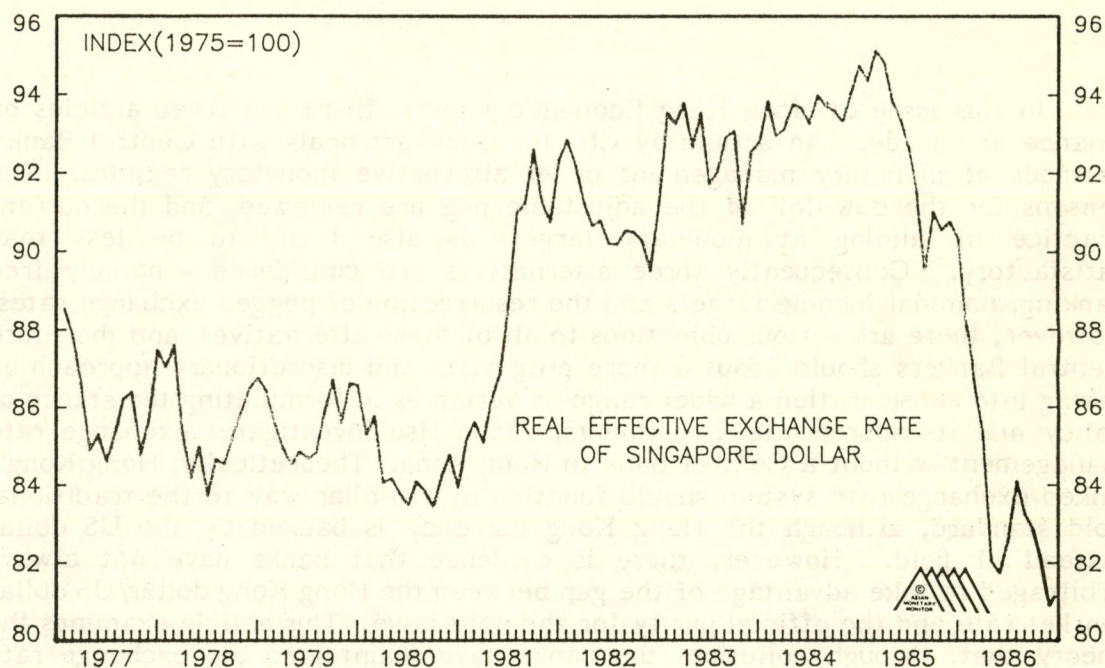
SINGAPORE: CHART 12
MONEY GROWTH AND THE STOCKMARKET



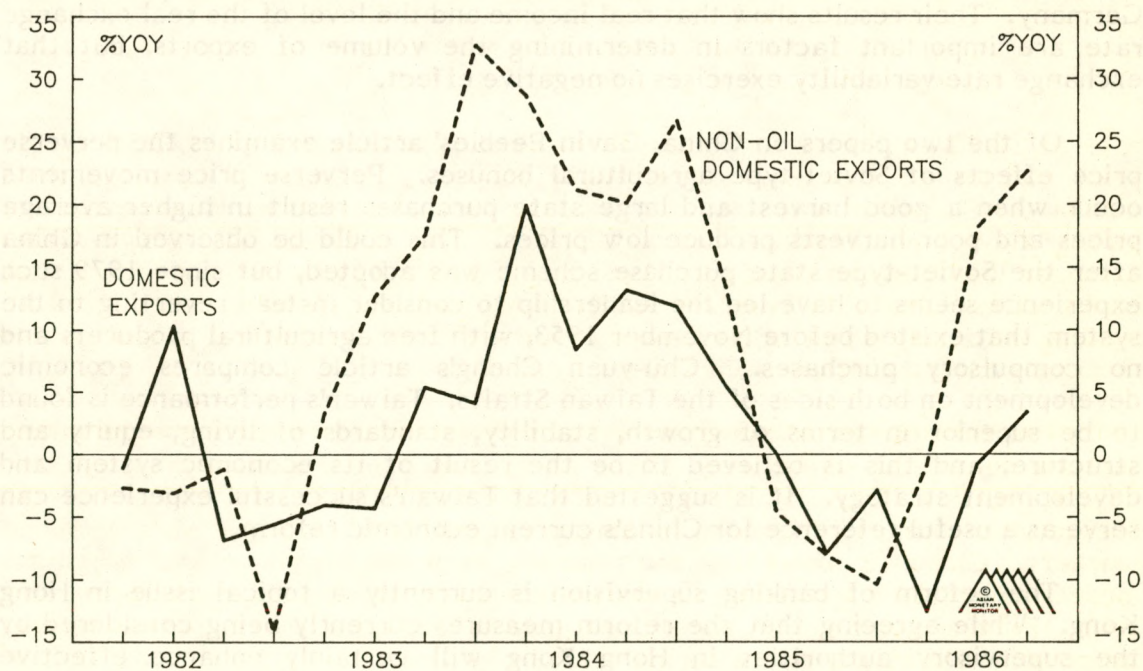
rate of 10.9% in the second quarter. Growth appeared to slow to 3.3% in the third quarter on a preliminary estimate basis but it is likely that the third quarter GNP number will later be revised upwards, and for the fourth quarter a strong export performance has virtually assured a reasonable growth rate. Stronger loan demand consequent upon the improving economy will ensure that banks utilise available reserves to increase domestic lending as opposed to lending into the Asian dollar market, consequently leading to a fall in the monetary capital outflow from Singapore.

The further rise in monetary growth which should result from the public sector's continuing stimulatory fiscal policy and a reduction in the monetary capital outflow from Singapore should provide further momentum to the recovery in domestic demand in Singapore and also to Singapore's financial markets. Chart 12 shows that the recovery in money supply growth which has already taken place has allowed a sharp recovery in Singapore's stock market this year. Further increases in the money growth rate should encourage a further improvement in equity prices during 1987.

SINGAPORE: CHART 13
REAL EFFECTIVE EXCHANGE RATE



SINGAPORE: CHART 14
COMPONENTS OF EXPORTS GROWTH



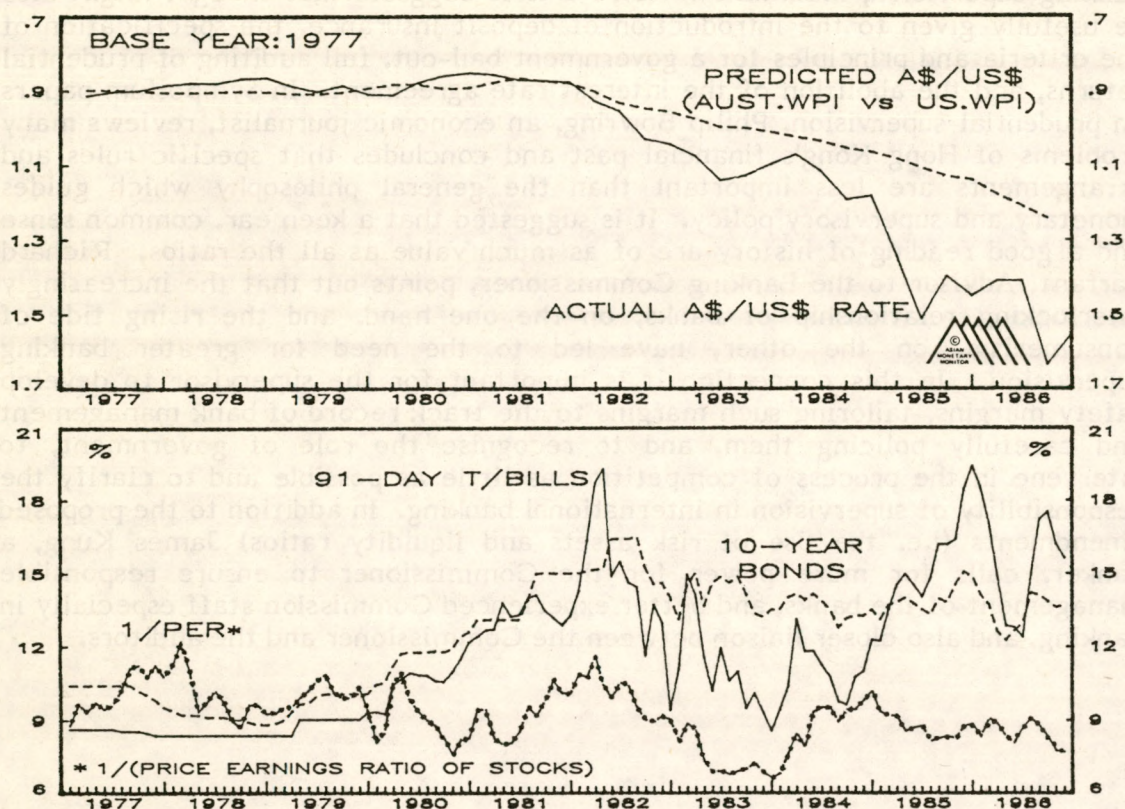
In this issue of Hong Kong Economic Papers, there are three articles on finance and trade. An article by Charles Goodhart deals with Central Banks' methods of monetary management under alternative monetary regimes. The reasons for the downfall of the adjustable peg are reviewed, and the current practice of aiming at monetary targets is also found to be less than satisfactory. Consequently three alternatives are considered - namely free banking, nominal income targets and the resurrection of pegged exchange rates. However, there are serious objections to all of these alternatives, and therefore Central Bankers should adopt a more pragmatic and discretionary approach by taking into consideration a wider range of variables in formulating the stance of policy and its appropriate adjustments. John Hsu investigates exchange rate management without a Central Bank in Hong Kong. Theoretically, Hong Kong's linked exchange rate system should function in a similar way to the traditional gold standard, although the Hong Kong currency is backed by the US dollar instead of gold. However, there is evidence that banks have not always arbitrated to take advantage of the gap between the Hong Kong dollar/US dollar market rate and the official parity for the note issue. This article examines the theory that, through collusion, the banks have maintained the exchange rate often at a level significantly different from official parity over a prolonged period of time because of money supply considerations. The article suggests that the result has been some measure of flexibility in the HK\$-US\$ exchange rate and monetary independence for Hong Kong. The effect of variability of exchange rates on international trade has long been a controversial subject. It is put to empirical test by Patrick Chan and Jim Wong in their article on Hong Kong's domestic exports to its major markets, namely the US, UK and West Germany. Their results show that real income and the level of the real exchange rate are important factors in determining the volume of exports, but that exchange rate variability exercises no negative effect.

Of the two papers on China, Gavin Peebles' article examines the perverse price effects of Soviet-type agricultural bonuses. Perverse price movements occur when a good harvest and large state purchases result in higher average prices and poor harvests produce low prices. This could be observed in China after the Soviet-type state purchase scheme was adopted, but since 1979 such experience seems to have led the leadership to consider instead reverting to the system that existed before November 1953, with free agricultural producers and no compulsory purchases. Chu-yuan Cheng's article compares economic development on both sides of the Taiwan Straits. Taiwan's performance is found to be superior in terms of growth, stability, standards of living, equity and structure, and this is believed to be the result of its economic system and development strategy. It is suggested that Taiwan's successful experience can serve as a useful reference for China's current economic reform.

The reform of banking supervision is currently a topical issue in Hong Kong. While agreeing that the reform measures currently being considered by the supervisory authorities in Hong Kong will certainly enhance effective

banking supervision, Maximillian Hall's article suggests that thought might also be usefully given to the introduction of deposit insurance, the specification of the criteria and principles for a government bail-out, full auditing of prudential returns, and the abolition of the interest rate agreement. In Symposium papers on prudential supervision, Philip Bowring, an economic journalist, reviews many problems of Hong Kong's financial past and concludes that specific rules and arrangements are less important than the general philosophy which guides monetary and supervisory policy. It is suggested that a keen ear, common sense and a good reading of history are of as much value as all the ratios. Richard Farrant, Advisor to the Banking Commissioner, points out that the increasingly interlocking relationship of banks, on the one hand, and the rising tide of consumerism, on the other, have led to the need for greater banking supervision. In this connection it is important for the supervisor to develop safety margins, tailoring such margins to the track record of bank management and carefully policing them, and to recognise the role of government, to intervene in the process of competition as little as possible and to clarify the responsibility of supervision in international banking. In addition to the proposed amendments (i.e. the use of risk assets and liquidity ratios) James Kung, a banker, calls for more power for the Commissioner to ensure responsible management of the banks, and better experienced Commission staff especially in banking, and also closer liaison between the Commissioner and the auditors.

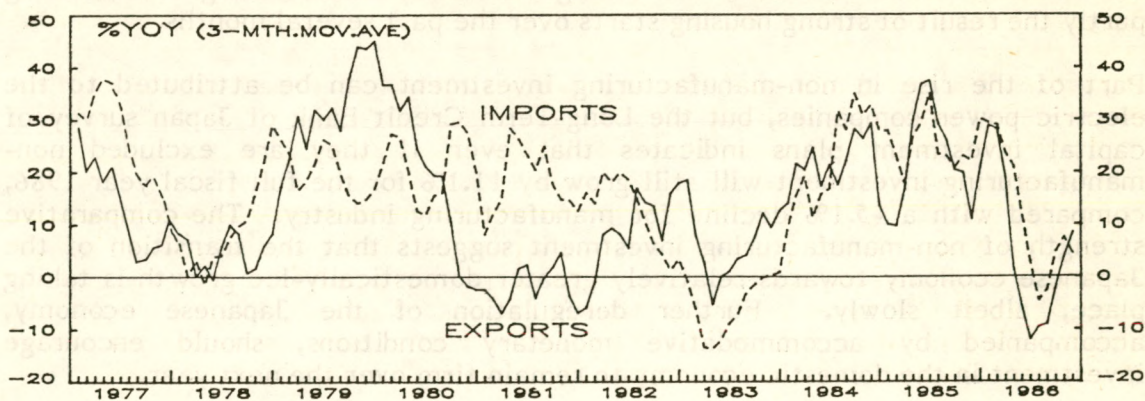
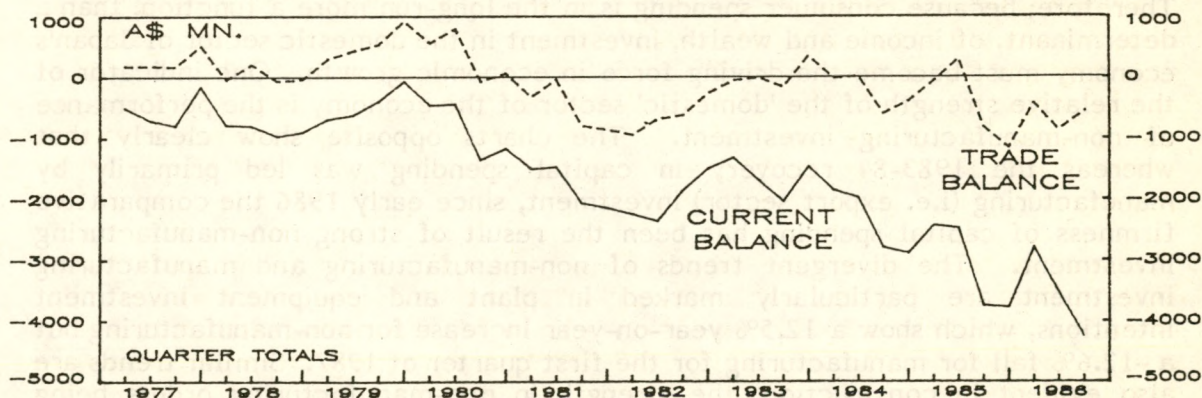
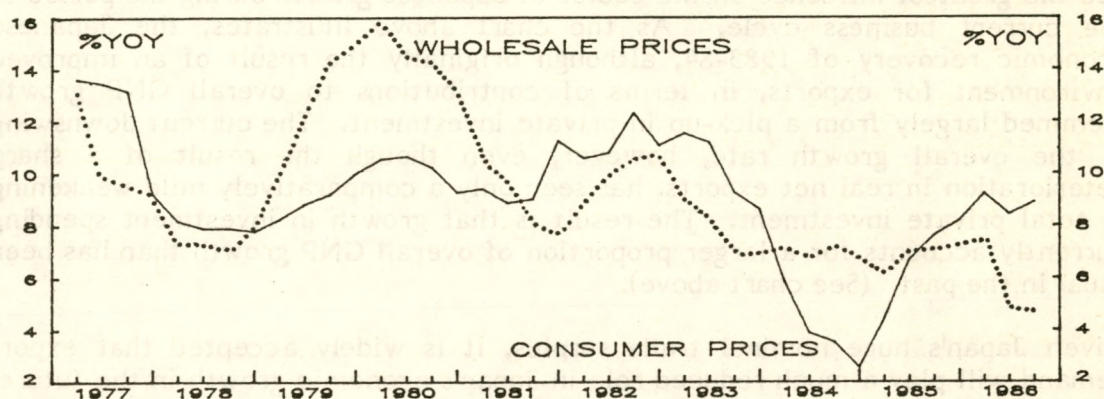
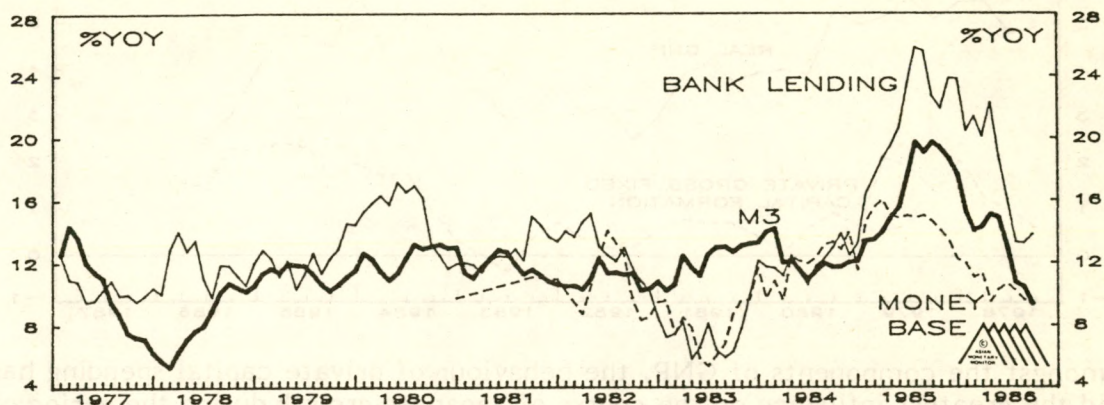
AUSTRALIA: RESERVE BANK STRINGENCY STRENGTHENS A\$



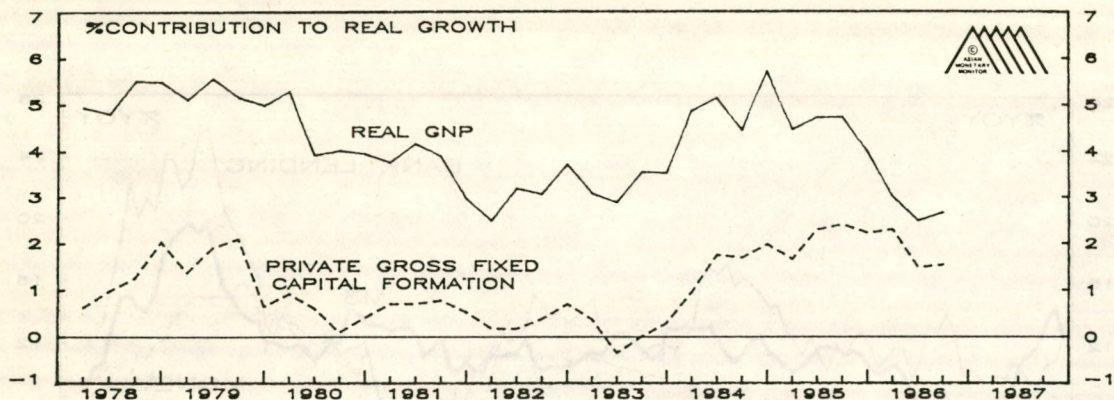
Base money growth peaked in Australia in March of 1985 at a 16% annual rate. Four months later, bank lending growth peaked at a 25.8% annual rate, while M3 growth peaked at a 19.7% rate in September of the same year. Thus, the growth in base money - over which the Reserve Bank has control - peaked before the growth rates in M3 or in bank lending. This implies that the slowdown in money growth has been caused by Reserve Bank policy rather than by a slowdown in loan demand due to the business cycle.

The sensitivity of the market to any perceived lack of will on the part of the Reserve Bank is illustrated by the reaction to the slight loosening of policy which occurred between April 1986 and June 1986 when year over year base money growth increased from 9.5% to 10.7%. The financial markets reacted violently to this easing. The A\$ fell from 74¢ to 66¢ and in order to arrest the decline the Reserve Bank was forced to raise short-term rates dramatically, with T-Bill rates rising from 12.4% in June to 17.5% in November 1986. All recent policy announcements warn against an early easing of money growth which implies that the monetary authority is eager not to repeat the experience of March-June.

The most recent trade figures, while subject to extraordinary revisions because of new reporting methods, have shown the trade account moving into a surplus on a monthly basis for the first time this year, as well as an improvement in the current account. The stock market has rallied strongly over the entire year in spite of very high bond yields (compare 1/PER to 10-Year Bond Yields in the Chart). If the Reserve Bank maintains its present policy, with the A\$ stable bond yields should decline from current high levels.



JAPAN: FIRM CAPITAL SPENDING WILL HELP TO SUPPORT THE ECONOMY

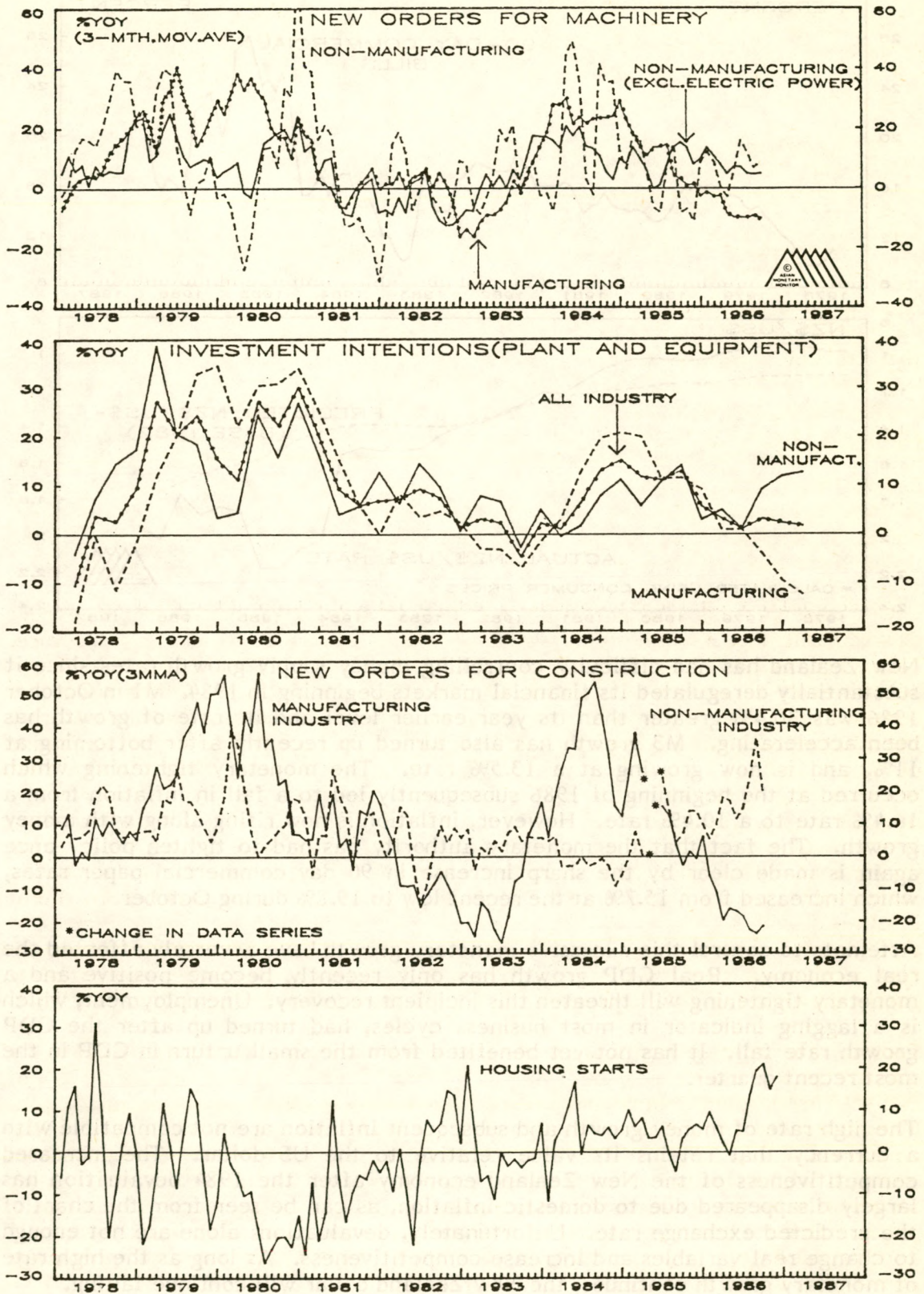


Amongst the components of GNP, the behaviour of private capital spending has had the greatest influence on the course of Japanese growth during the period of the current business cycle. As the chart above illustrates, the Japanese economic recovery of 1983-84, although originally the result of an improved environment for exports, in terms of contributions to overall GNP growth stemmed largely from a pick-up in private investment. The current downswing in the overall growth rate, however, even though the result of a sharp deterioration in real net exports, has seen only a comparatively mild weakening in total private investment. The result is that growth in investment spending currently accounts for a larger proportion of overall GNP growth than has been usual in the past. (See chart above).

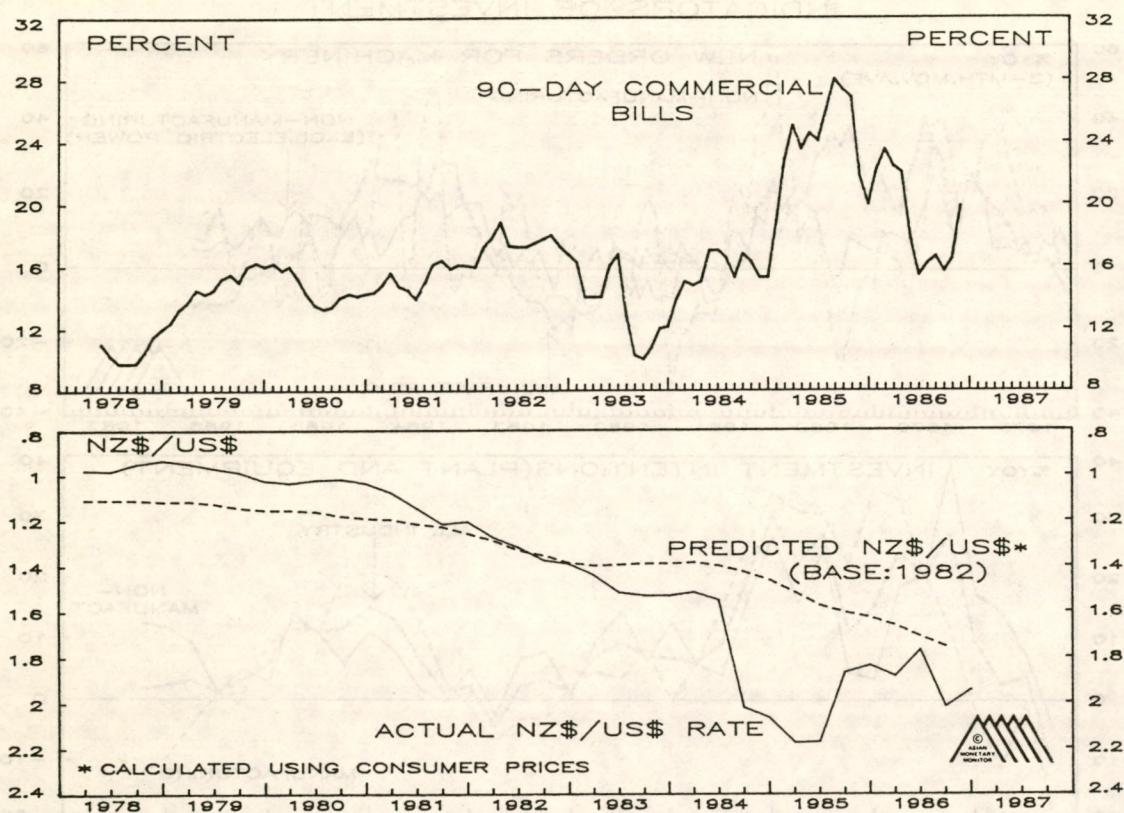
Given Japan's huge nominal trade surplus, it is widely accepted that export demand will play a much reduced role in Japan's economic growth in the future. Therefore, because consumer spending is in the long-run more a function, than a determinant, of income and wealth, investment in the domestic sector of Japan's economy must become the driving force in economic growth. One indicator of the relative strength of the 'domestic' sector of the economy is the performance of non-manufacturing investment. The charts opposite show clearly that whereas the 1983-84 recovery in capital spending was led primarily by manufacturing (i.e. export sector) investment, since early 1986 the comparative firmness of capital spending has been the result of strong non-manufacturing investment. The divergent trends of non-manufacturing and manufacturing investment are particularly marked in plant and equipment investment intentions, which show a 12.5% year-on-year increase for non-manufacturing but a -12.6% fall for manufacturing for the first quarter of 1987. Similar trends are also evident in construction, the strength in non-manufacturing orders being partly the result of strong housing starts over the past several months.

Part of the rise in non-manufacturing investment can be attributed to the electric power companies, but the Long-Term Credit Bank of Japan survey of capital investment plans indicates that even if they are excluded non-manufacturing investment will still grow by 11.1% for the full fiscal year 1986, compared with a -5.1% decline for manufacturing industry. The comparative strength of non-manufacturing investment suggests that the transition of the Japanese economy towards relatively greater domestically-led growth is taking place, albeit slowly. Further deregulation of the Japanese economy, accompanied by accommodative monetary conditions, should encourage investment in the domestic economy to remain firm over the next year.

JAPAN INDICATORS OF INVESTMENT



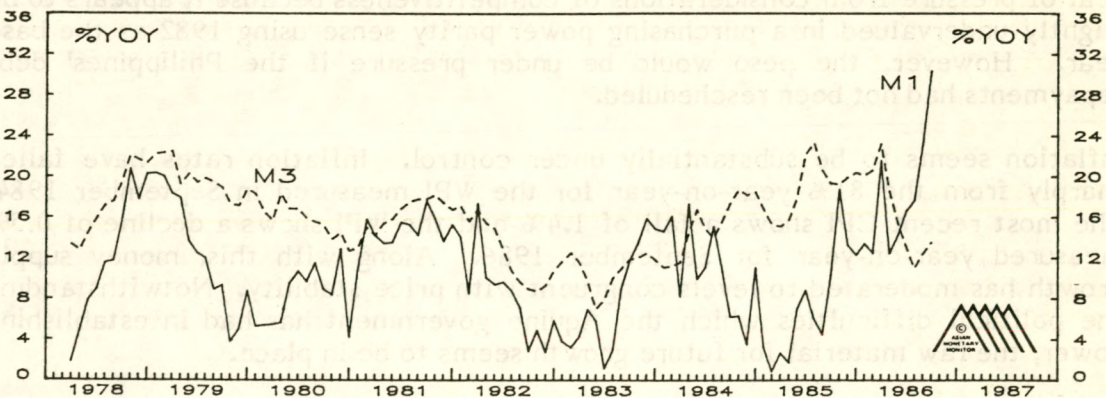
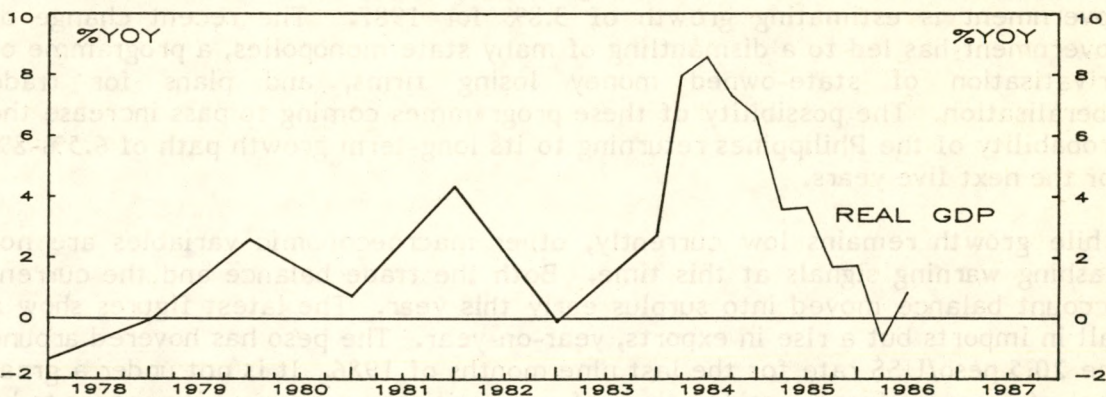
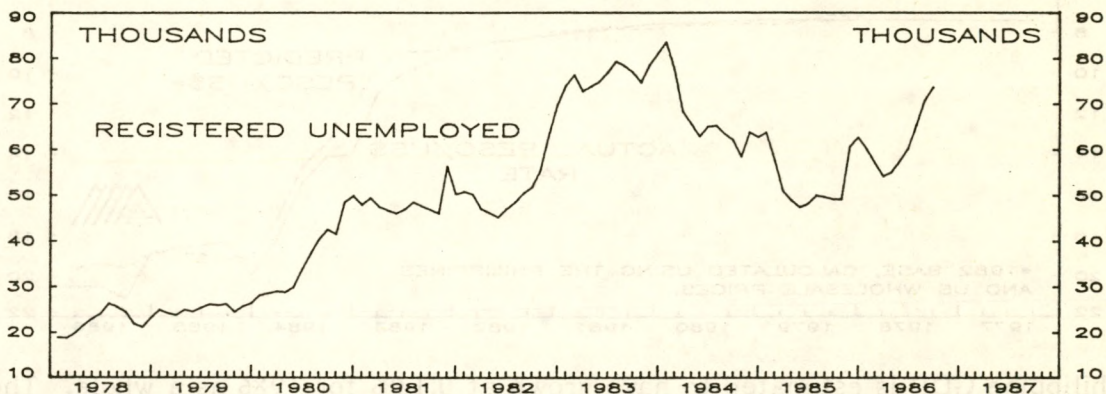
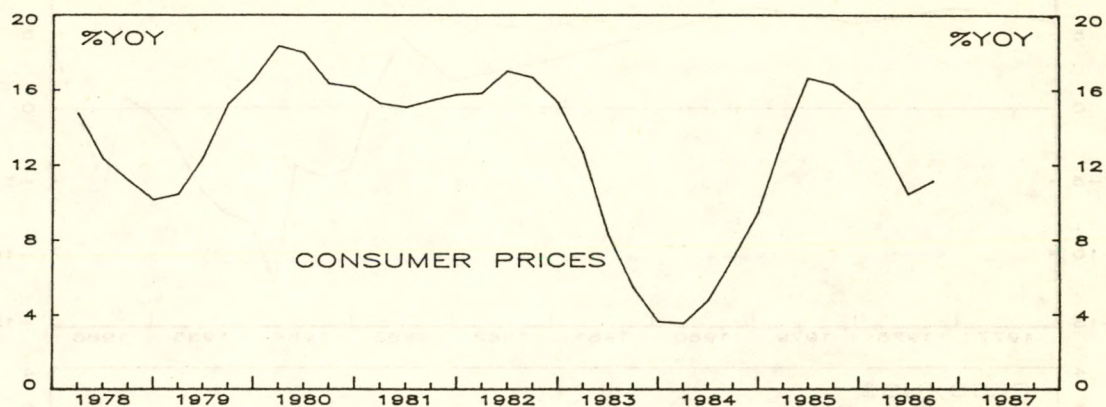
NEW ZEALAND: EXCESSIVE MONETARY GROWTH STILL THREATENS NZ\$



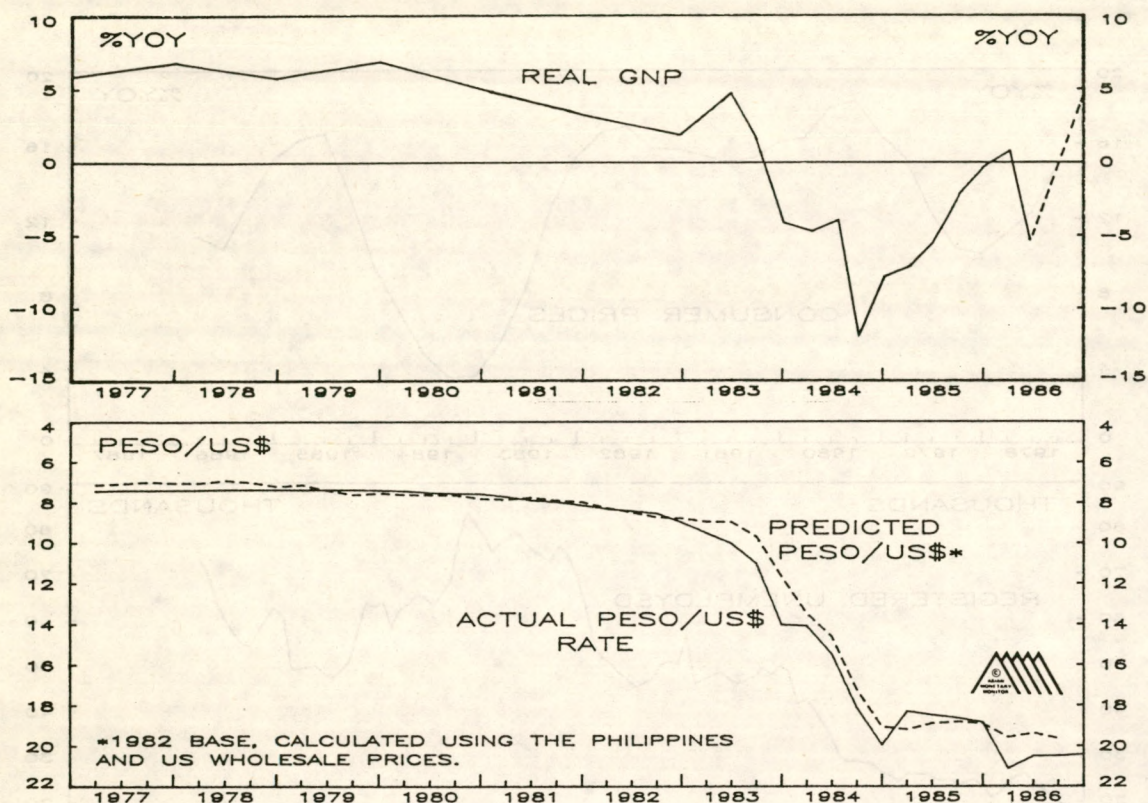
New Zealand has had difficulty controlling money supply growth rates since it substantially deregulated its financial markets beginning in 1984. M1 in October 1986 was 30.4% greater than its year earlier level and its rate of growth has been accelerating. M3 growth has also turned up recently after bottoming at 11%, and is now growing at a 13.5% rate. The monetary tightening which occurred at the beginning of 1986 subsequently led to a fall in inflation from a 16.4% rate to a 10.4% rate. However, inflation is now rising along with money growth. The fact that the monetary authority has had to tighten policy once again is made clear by the sharp increase in 90 day commercial paper rates, which increased from 15.7% at the recent low to 19.8% during October.

Attempts to control this excessive monetary growth have adversely affected the real economy. Real GDP growth has only recently become positive and a monetary tightening will threaten this incipient recovery. Unemployment, which is a lagging indicator in most business cycles, had turned up after the GDP growth rate fall. It has not yet benefited from the small upturn in GDP in the most recent quarter.

The high rate of money growth and subsequent inflation are not compatible with a currency that retains its value relative to the US dollar. The increased competitiveness of the New Zealand economy after the 1984 devaluation has largely disappeared due to domestic inflation, as can be seen from the chart of the predicted exchange rate. Unfortunately, devaluations alone are not enough to change real variables and increase competitiveness. As long as the high rate of monetary growth continues, the New Zealand dollar will continue falling.



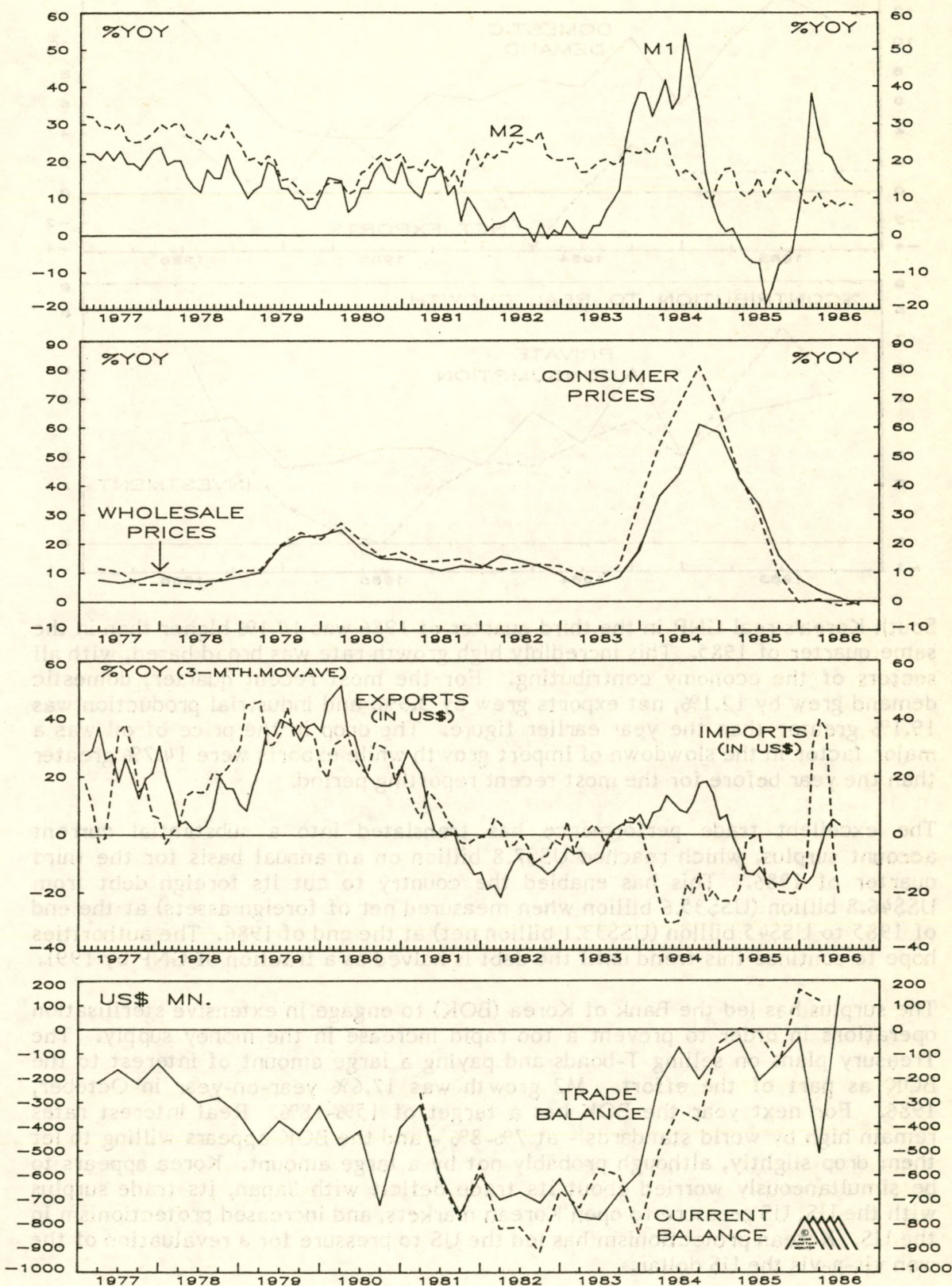
PHILIPPINES: DESPITE POLITICAL DIFFICULTIES, GROWTH IS LIKELY IN 1987



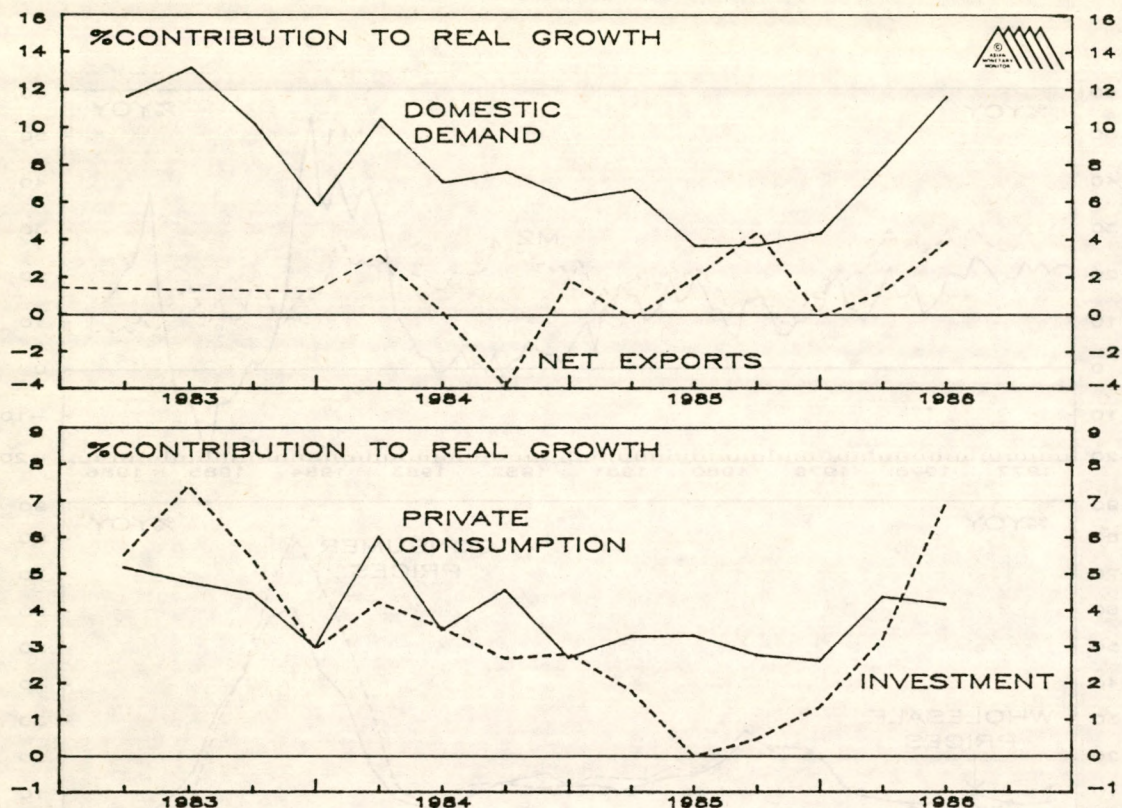
Philippine GDP is estimated to have grown at 0.13% for 1986 as a whole. The government is estimating growth of 3.8% for 1987. The recent change of government has led to a dismantling of many state monopolies, a programme of privatisation of state-owned money losing firms, and plans for trade liberalisation. The possibility of these programmes coming to pass increase the probability of the Philippines returning to its long-term growth path of 6.5%-8% for the next five years.

While growth remains low currently, other macroeconomic variables are not flashing warning signals at this time. Both the trade balance and the current account balance moved into surplus early this year. The latest figures show a fall in imports but a rise in exports, year-on-year. The peso has hovered around the 20.5 peso/US\$ rate for the last nine months of 1986. It is not under a great deal of pressure from considerations of competitiveness because it appears to be slightly undervalued in a purchasing power parity sense using 1982 as the base year. However, the peso would be under pressure if the Philippines' debt repayments had not been rescheduled.

Inflation seems to be substantially under control. Inflation rates have fallen sharply from the 81% year-on-year for the WPI measured in September 1984. The most recent CPI shows a fall of 1.4% and the WPI shows a decline of 0.5% measured year-on-year for September 1986. Along with this, money supply growth has moderated to levels congruent with price stability. Notwithstanding the political difficulties which the Aquino government has had in establishing power, the raw material for future growth seems to be in place.



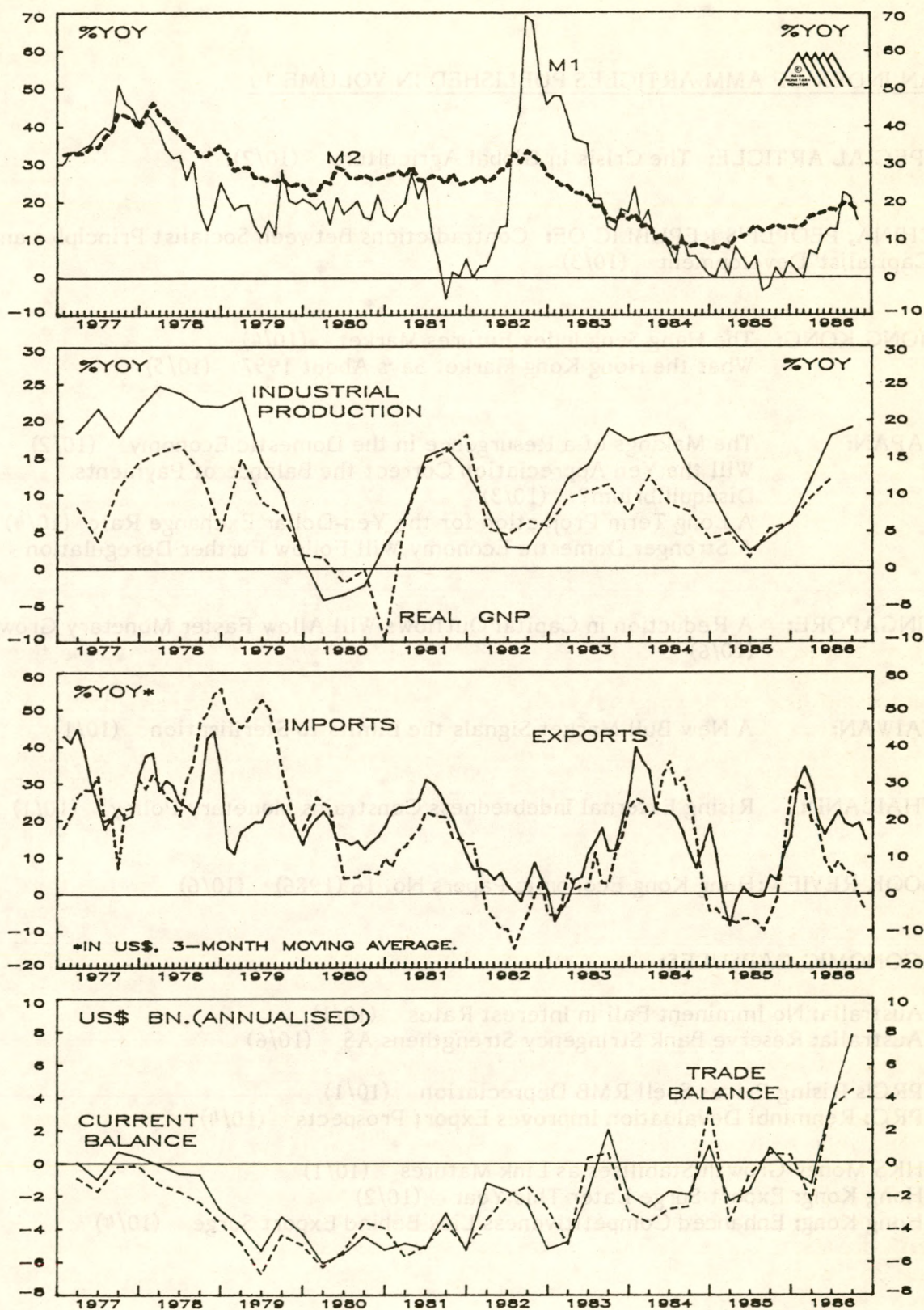
SOUTH KOREA: CURRENT ACCOUNT SURPLUS USED TO REDUCE FOREIGN DEBT



South Korea's real GNP in the third quarter of 1986 was 14.1% higher than in the same quarter of 1985. This incredibly high growth rate was broad based, with all sectors of the economy contributing. For the most recent quarter, domestic demand grew by 12.1%, net exports grew by 3.9%, and industrial production was 19.1% greater than the year earlier figure. The drop in the price of oil was a major factor in the slowdown of import growth while exports were 14.7% greater than the year before for the most recent reporting period.

The excellent trade performance has translated into a substantial current account surplus, which reached US\$7.8 billion on an annual basis for the third quarter of 1986. This has enabled the country to cut its foreign debt from US\$46.8 billion (US\$35.6 billion when measured net of foreign assets) at the end of 1985 to US\$45 billion (US\$33.1 billion net) at the end of 1986. The authorities hope to continue this trend until the debt is halved as a fraction of GNP by 1991.

The surplus has led the Bank of Korea (BOK) to engage in extensive sterilisation operations in order to prevent a too rapid increase in the money supply. The Treasury plans on selling T-bonds and paying a large amount of interest to the BOK as part of the effort. M2 growth was 17.6% year-on-year in October, 1986. For next year the BOK has a target of 15%-18%. Real interest rates remain high by world standards - at 7%-8% - and the BOK appears willing to let them drop slightly, although probably not by a large amount. Korea appears to be simultaneously worried about its trade deficit with Japan, its trade surplus with the US, US pressure to open Korean markets, and increased protectionism in the US. Korean protectionism has led the US to pressure for a revaluation of the won vis-a-vis the US dollar.



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